S. HRG. 99-246, PT. VI

TAX REFORM PROPOSALS—VI

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JUNE 19, 1985

(Taxpayer Organizations and Public Interest Groups)

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

51-219 O WASHINGTON : 1986

S361-21

COMMITTEE ON FINANCE

BOB PACKWOOD, Oregon, *Chairman*

ROBERT J. DOLE, Kansas	RUSSELL B. LONG, Louisiana
WILLIAM V. ROTH, JR., Delaware	LLOYD BENTSEN, Texas
JOHN C. DANFORTH, Missouri	SPARK M. MATSUNAGA, Hawaii
JOHN H. CHAFEE, Rhode Island	DANIEL PATRICK MOYNIHAN, New York
JOHN HEINZ, Pennsylvania	MAX BAUCUS, Montana
MALCOLM WALLOP, Wyoming	DAVID L. BOREN, Oklahoma
DAVID DURENBERGER, Minnesota	BILL BRADLEY, New Jersey
WILLIAM L. ARMSTRONG, Colorado	GEORGE J. MITCHELL, Maine
STEVEN D. SYMMS, Idaho	DAVID PRYOR, Arkansas
CHARLES E. GRASSLEY, Iowa	

WILLIAM DIEFENDERFER, *Chief of Staff*
MICHAEL STERN, *Minority Staff Director*

CONTENTS

PUBLIC WITNESSES

	Page
Baumbush, Peter L., treasurer, Fair Tax Foundation, accompanied by Livia Bardin	140
Campbell, Nancy Duff, cochair, Coalition on Woman and Taxes and managing attorney, National Women's Law Center	34
Citizens For Tax Justice, Robert S. McIntyre, director of Federal tax policy	6
Coalition on Women and Taxes, Nancy Duff Campbell, cochair	34
Davidson, James D., chairman, National Taxpayers Union	88
Fair Tax Foundation, Peter L. Baumbush, treasurer, accompanied by Livia Bardin	140
Forman, Maxine, cochair, Coalition on Women and Taxes	70
Goffman, Joseph, staff attorney, Public Citizen's Congress Watch	100
Haskell, Floyd K., chairman, the Taxpayer's Committee	2
McIntyre, Robert S., director of Federal Tax Policy, Citizens For Tax Justice	6
National Taxpayers Union, James D. Davidson, chairman	88
Public Citizen's Congress Watch, Joseph Goffman, staff attorney	100
The Taxpayer's Committee, Floyd K. Haskell, chairman	2

ADDITIONAL INFORMATION

Committee press release	1
Prepared statement of the Taxpayer's Committee	4
Prepared statement of the Citizens for Tax Justice	9
Prepared statement of Nancy Duff Campbell and Maxine Forman	35
Prepared statement of the Women's Equity Action League	72
Prepared statement of James D. Davidson	91
Prepared statement of Joseph Goffman	103
Prepared statement of Peter L. Baumbush	142

COMMUNICATIONS

Common Cause	150
Citizens for a Sound Economy	168
Article by Robert Capozzi and Jeffrey C. Smith	172

TAX REFORM PROPOSALS—VI

WEDNESDAY, JUNE 19, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Grassley, Long, Moynihan, and Bradley.

[The press release announcing the hearing follows:]

[Press release, June 11, 1985]

CHAIRMAN PACKWOOD ANNOUNCES FINANCE TAX REFORM HEARINGS

Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance, today announced further Committee hearings in June on President Reagan's tax reform proposal.

Chairman Packwood announced the second five days of hearings, as follows:

On Wednesday, June 19, 1985, the Committee will receive testimony from witnesses representing taxpayer organizations and public interest groups.

The Committee will hear from public witnesses on the impact of the tax reform proposal on capital formation on Thursday, June 20, 1985.

On Tuesday, June 25, 1985, invited witnesses will discuss the issue of whether the tax-exempt use of industrial development bonds ought to continue.

On Wednesday, June 26, 1985, public witnesses will testify on research and development tax credits, and venture capital formation.

The Committee will receive testimony from economists on the impact of the President's tax reform proposal on the economy on Thursday, June 27, 1985.

All hearings will begin at 9:30 a.m. and will be held in Room SD-215 of the Dirksen Senate Office Building.

The CHAIRMAN. The hearing will come to order, please.

This is a continuation of one of many hearings we will be having on the tax bill through the rest of this month and July and September. Whether we go into October or not will depend upon how rapidly the House is moving. We are trying to get as broad a spectrum of testimony as we can from as many groups that include a cross-section of this country as possible. And today we have a cross-section of representatives from tax reform groups and from people who have been fighting before this committee for a long period of time for justice in tax policy.

We will start with a panel consisting of a former colleague of ours, Floyd Haskell, who we worked with in this committee for 6 years, and Robert McIntyre, and Nancy Duff Campbell, and Maxine Forman, if you all want to take your places. But we will start off in the order of the witness list with Senator Haskell.

Senator MOYNIHAN. Mr. Chairman, would you allow just one moment? I just would like to welcome our guests and of course our colleague and friend Senator Haskell, and just add, should I have to leave, that this is the fiftieth anniversary of the passage by the United States Senate of the Social Security Act of 1935, and we are having a series of statements on the floor. Only because I have agreed to participate in this commemoration will I perhaps not hear all of this testimony.

Senator HASKELL. Thank you, Senator Moynihan.

The CHAIRMAN. It's good to have you with us, Floyd.

Senator HASKELL. Thank you.

STATEMENT BY SENATOR FLOYD K. HASKELL, CHAIRMAN, THE TAXPAYER'S COMMITTEE, WASHINGTON, DC

Senator HASKELL. Mr. Chairman, it is a pleasure to be here. And I understand from the letter I received that the statement will be included in the record in full.

The CHAIRMAN. I should say to all of the witnesses that all of your statements will be in the record. You were very kind to get them in ahead of time so that I could read them last night and this morning, and they will be in the record in their entirety.

Senator HASKELL. Well, I certainly will summarize mine.

Mr. Chairman, obviously you and your committee have a full plate ahead of you, because tax reform which has been sort of wandering around for a long time is finally front and center.

Clearly, there are many reasons why there should be tax reform; not the least of them is economic efficiency, the attempt to get simplicity, which is a drive on behalf of many people who really resent the complexities of our Code, and the complexities of our Code make it very difficult to administer. And therefore, there should be reform for a great many reasons.

In my opinion, however, Mr. Chairman, the overriding reason for reform is the effect that our tax laws have had on taxpayer morale. It is not surprising news to either you or Senator Moynihan that the Harris Poll in 1970—80 percent of respondents found that, they felt anyway, their opinion was, the tax laws favored the rich and the powerful. That is not news. Nor is it probably news that the Yankelovich Poll taken for the IRS last year—the response, again, to the same type of question was again 80 percent.

However, in the Yankelovich Poll there is an item which was startling to me. They asked the people polled, "What do you think about cheating on taxes?" One-third of the respondents said, well, they thought there was nothing wrong with that; another third were ambivalent on the issue, didn't know, "Well, maybe yes, maybe no," and only one-third felt that it was wrong to do it.

Now, this, to me, is a change of public attitude very much for the worse; but when you think about it, it really isn't so odd. Everybody reads in the newspapers, sees on TV, hears on the radio about tax shelters. The vast majority of the people in this country don't have the money to invest in tax shelters. Their response is to cheat.

Now, the Commissioner of Internal Revenue, Commissioner Egger, in a speech of about a year ago would I think support what

I am saying, because he said that cheating was a form of revenge—that is his word, revenge—against a system believed to be unfair.

Now, obviously this situation can't be allowed to continue for the public morale of this country and the public morals of this country. To my way of thinking, reform is the answer. You have in your committee, Mr. Chairman, the Bradley-Gephart Bill. This is a true reform bill, something that could be embraced as fair. The Treasury Department in November came out with Treasury-1. This, again, is a true reform bill. That could be embraced as fair.

Treasury-2—I use that word because most people use it, the plan that the President articulated a couple of weeks ago—Treasury-2, on the other hand, is really a half-way measure. It is surely an improvement on the present system, but it is a great retreat from Treasury-1. For example, in Treasury-2, more families in the over-$200,000 group get tax cuts than those in the mid-income group. Capital gains are taxed at one-half the rate of wage income; the oil industry's intangible drilling cost on successful wells is retained; and organized labor got what it wanted on fringe benefits; to say nothing of organized charity.

Americans, in my view, are going to say, if this bill is passed, "So, what's new? Business as usual."

Probably if Treasury-2 was adopted, there would be a bit of euphoria when it became law, but in my view the cynicism will soon return.

So, Mr. Chairman and Senator Moynihan, I strongly urge this committee to look at Bradley-Gephart and at Treasury-1 as a basic blueprint.

Thank you very much.

The CHAIRMAN. Thank you.

Mr. McIntyre.

[Senator Haskell's written testimony follows:]

THE TAXPAYER'S COMMITTEE

133 NORTH CAROLINA AVENUE, S.E.
WASHINGTON, D.C. 20003
(202) 546-2442

Donald C. Alexander
Alan J. Auerbach
Mortimer M. Caplin
Sheldon S. Cohen
Archibald Cox
Thomas F. Field
Harvey Galper
Martin D. Ginsburg
Floyd K. Haskell
Jerome Kurtz
Donald C. Lubick
Paul McDaniel
Robert R. Nathan
John S. Nolan
Joseph L. Rauh, Jr.
Samantha Sanchez
Ruth Schapiro
Emil Sunley
David S. Tatel
Thomas A. Troyer

TESTIMONY OF

FLOYD K. HASKELL

before the

SENATE FINANCE COMMITTEE

on June 19,1985

Mr. Chairman, members of the Committee, it is a pleasure to appear before you and testify on the subject of tax reform. I am chairman of The Taxpayer's Committee which is a nonpartisan, non-profit organization whose principal function is public education in the tax field.

Tax reform has been lurking around the corridors for many years but now, for the first time, it is front and center. There are, of course, many reasons why our tax laws should be reformed. We all know of their incredible economic inefficiency. We all know that their complexity baffles and infuriates the American public. We all know that their complexity makes them almost impossible to administer.

These are not insignificant flaws and, of course, are valid reasons for reform. To me, however, the most important reason for reform is the effect our laws have had on public morale.

In 1970 the Harris pollsters asked whether tax law favored the rich and powerful. 80% responded in the affirmative. Last year the Yankelovich pollsters, in a survey commissioned by the Internal Revenue Service, asked the same

question and got the same 80% response.

This is not exactly surprising news. But there is another finding in the Yankelovich poll that that is. It certainly startled me. When asked whether cheating on taxes was alright, one-third answered in the affirmative, one-third were ambivalent and only one-third condemned cheating.

Unfortunately, when you think about it, the reason for this attitude becomes very clear. Americans read and hear about large organizations and wealthy individuals paying little or no tax. Tax shelters are touted in the daily press and in TV and radio commercials.

Americans know that they pay taxes and that it takes money to invest in a shelter. The vast majority don't have any extra cash with which to invest. So they cheat. That's their shelter. In fact, the incumbent Commissioner of Internal Revenue has referred to cheating on taxes as a form of revenge against an unfair system.

Obviously this can't be allowed to go on.

The clear remedy is a set of tax laws that people can embrace as fair.

The Bradley-Gephardt bill in your committee is such a bill. Another is Treasury I published last November. Some aspects of each differ, but both are true reform measures.

Treasury II, which was the subject of the President's address to the nation on June 4, is a halfway measure. It is an improvement over our present system, but it certainly is nothing that Americans can be expected to embrace as fair. Its retreats from Treasury I are too substantial.

In Treasury II -- more families in the over $200,000 group get tax cuts than those in the mid-income groups. Capital gains are taxed at one-half the rate of wage income. The oil industry's intangible drilling costs on successful wells is retained. Organized labor got what it wanted in fringe benefits.

Americans are going to say -- "So what's new? Business as usual". There may be a moment of euphoria if Treasury II becomes law, but cynicism soon will return.

I strongly urge this committee to regard the Bradley-Gephardt bill and Treasury I as the basic blueprints from which to frame legislation.

Floyd K. Haskell
The Taxpayer's Committee
133 No. Carolina Ave.S.E.
Washington, D.C., 20003

STATEMENT BY ROBERT S. McINTYRE, DIRECTOR OF FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. MCINTYRE. Good morning, Senator.

The CHAIRMAN. I don't know if you were here when I indicated your statement will be in the record in its entirety, and if you can abbreviate it we would appreciate it.

Mr. MCINTYRE. Thank you, Senator.

I appreciate the opportunity to be here. As you know, our coalition of public interest, labor, and grass roots citizens groups represents tens of millions of average Americans. You also know, I am sure, that we have long felt that tax overhaul was absolutely necessary to bring fairness and economic common sense back to our tax laws. As a result, we were delighted with the President's speech, which in many ways sounded like one of ours, a good populist speech urging a fairer tax system.

Unfortunately, we are very disappointed with the President's program. We don't think it does an adequate job of closing the loopholes and ending the tax dodges. We don't think it does enough for the average taxpayer, and we don't think it constitutes the basic reform that the Tax Code needs.

Over the last decade or so, the tax laws have become, by our lights at least, increasingly unfair to middle and lower income Americans. In fact, for most Americans the reality has been that their taxes have been going up and up. Lower income people have seen their taxes more than double since 1978. Middle income Americans have seen their taxes go up by 15 to 20 percent. And yet, of course, the government is not collecting more money. Because, at the same time, taxes in the corporate sector and taxes on upper income Americans have gone down. We now see hundreds,

probably thousands, of our major companies no longer paying taxes. General Electric, Boeing, Weyerhaeuser, the list goes on and on. We see thousands of very upper income Americans, according to the IRS, who no longer pay taxes. And that is the tax shift which has occurred over the past decade, where ordinary taxpayers have paid more and those best-off taxpayers have paid less.

We think that reversing this tax shift is what tax reform ought to be all about. And we believe that is what the average American thinks as well, which is why so many ordinary American taxpayers are excited about the prospect of reform.

Because the Administration's tax plan does not reverse the tax shift, we do not think it constitutes real reform. To the contrary, the Administration plan continues previous policies favoring the best-off Americans. It doesn't really redress the imbalance between individuals and corporations, and it doesn't deliver the knock-out blow to tax shelters and economic distortions that the country needs to sustain long-term growth. In fact, the Administration plan as now written would exempt the lion's share of business profits, through such things as faster depreciation even than current law and continued special preferences for the oil and gas industry. It would exempt half of the predominate form of income of the best-off Americans, capital gains. And it would allow the continued exploitation of tax shelters. On top of this, it has very, very large rate cuts for corporations and the very richest Americans. As a result, it is more of the same as far as we can see.

Not only that, but we are convinced, and I think many people are starting to agree, that the Administration bill is a long-term revenue loser of large proportion.

Insofar as the bill does lose revenue, it is going to have to be made up somehow, and we are worried that that revenue will be made up by even higher taxes on middle and low income Americans. As you know, many of the business lobbyists are already advocating some kind of a national sales tax or other program to increase taxes on our constituents, in many cases by tripling them.

We think the Congress can design a fair and economically sensible tax system and that the Administration program can provide a beginning. But unless basic changes are made in the program, we do not think it will satisfy what the American public wants.

Now, what kind of changes are we talking about? We are talking about real depreciation reform that actually taxes businesses on what they make and not on some figment of their accountant's imagination. We are talking about asking the oil and gas industry to pay taxes just like working people, not get subsidized. We are talking about treating capital gains just like other income. We are talking about getting rid of the large rate cuts at the upper end of the income spectrum and giving some more relief to people whose taxes have gone up over the last decade—that is, middle income Americans.

If you do these things and make some other changes we have suggested in our testimony, we think you will have earned your place in history as "the great tax reformers." On the other hand, if you follow the lead of the President, which we think is just more of the same, we are going to have to be back here again and again asking for tax justice on behalf of middle income Americans.

Thank you.
The CHAIRMAN. Thank you.
Ms. Campbell.
[Mr. McIntyre's testimony follows:]

Citizens for Tax Justice
1313 L Street NW • Washington, DC 20005 • (202) 898-3369

Statement of Robert S. McIntyre
Director of Federal Tax Policy, Citizens for Tax Justice
Before the Senate Committee on Finance
Concerning Fundamental Tax Reform
June 19, 1985

I appreciate the opportunity to appear before the Committee today on behalf of Citizens for Tax Justice. Our coalition of public interest, labor, and grassroots citizens groups represents tens of millions of average American taxpayers who have a vital stake in restoring fairness and economic common sense to our tax laws.

Let me begin by noting that we, probably like most Americans, were delighted by the President's May 28 speech, in which he promised us real reform of the tax code. We were especially pleased when the President told the big corporations and wealthy tax avoiders now snubbing their noses at the tax collector that "the free rides are over." As we all know, there is no way that tax relief can be provided to hard-working average American taxpayers unless those individuals and companies now not paying their fair share are brought back onto the tax rolls.

Unfortunately, the President's tax program does not measure up to the promises of his speech. Because the plan does not do an adequate job of closing the loopholes and ending the tax dodges, it does not constitute the basic reform that the tax code so desperately needs. And, as a result, the plan does not offer real long-run tax relief to middle-income Americans.

In deciding what we want from tax reform, it helps to step back and ask an even more fundamental question: What do we want from the tax system? For most people, the answer, we think, is fairly straightforward. We want the tax system to raise enough money to fund the government, and to do so in a way that is fair and that makes economic sense. To achieve these goals, a good tax system should ask individuals and businesses to pay taxes on what they actually earn, and taxes should be assessed based on taxpayers' ability to pay them. As this Committee wisely noted back in 1969, "only by sharing the tax burden on an equitable basis is it possible to keep the tax burden at a level which is tolerable for all taxpayers."

Over the past decade, however, the principle of sharing the tax burden on an equitable basis has largely been ignored. The reality is that most middle and lower income American families have seen their taxes steadily increase--despite numerous so-called "tax cuts," including the 1981 changes in tax rates. Because of inflation-driven bracket creep and, to a lesser degree, higher social security taxes, the federal tax rate on families at the poverty level has more than doubled since 1978. Middle-income families have experienced tax increases of 15 to 20 percent over the same period. At the same time, the tax burden on corporations and the wealthiest individuals has dramatically declined, as more and more loopholes, shelters, and "incentives" have been added to the tax code. Reversing this tax shift is at the heart of what real tax reform is all about, and it is precisely

the hope for such a reversal that has average Americans excited at the prospect of reform.

But, despite some good points, the administration's program does not come even close to delivering real tax reform. Instead of reversing the tax shift, it continues previous policies favoring the richest Americans and it fails to redress the imbalance between individuals and corporations. Moreover, it does not deliver the knockout blow to tax shelters and economic distortions that the country needs to sustain long-term growth.

The administration proposes to exempt the lion's share of business profits, through such things as even faster depreciation write-offs than current law and continued special preferences for the oil and gas industry. It would exempt half of the predominant form of income enjoyed by the extremely well-off--capital gains--and would allow the continued exploitation of tax shelters. On top of this, the administration would cut the statutory corporate tax rate by 28 percent and slash the top personal tax rate by 30 percent from current law, to only half the rate that applied when the administration took office.

As a result, the administration proposal provides only modest tax relief to middle-income Americans. And even that small relief is likely to be short lived. Because of its failings, the administration program appears to entail a substantial long-term revenue loss--at a time when tax revenues are already far short of paying for the costs of government services. Inevitably, that revenue shortfall will have to be made up, and lobbyists and politicians are already talking about stiff new taxes on middle and lower income families as a way of doing so.

Congress <u>can</u> design a truly fair and economically sensible tax program that provides real tax relief to middle income taxpayers. But to do so, it must make a number of basic changes in the program the President has presented. To begin with, Congress must address the most salient defect in the President's tax plan--from the point of view of fairness, economic growth, and revenue sufficiency: the program's failure to restore the corporate income tax.

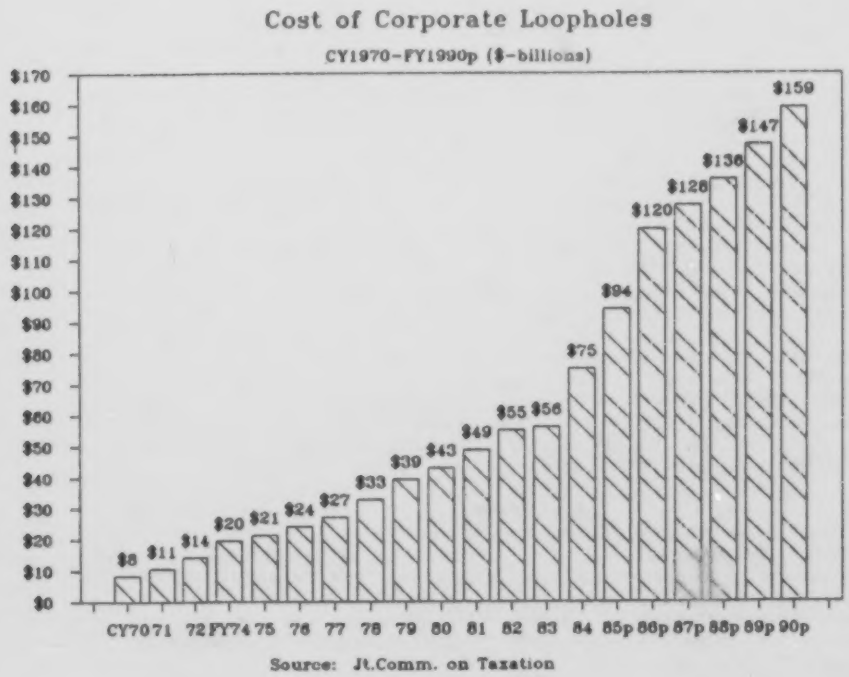
THE DECLINE OF THE CORPORATE INCOME TAX

The decline of the corporate income tax--and the resulting shift in the tax burden onto average wage-earners--has been well documented and well publicized. Studies by the staff of the Joint Committee on Taxation and Citizens for Tax Justice have found that the average effective corporate rate on the nation's largest companies has fallen to 14-16 percent. The Congressional Budget Office reports that the average effective corporate tax rate has been cut in half since 1980. In Citizens for Tax Justice's October 1984 report, <u>Corporate Taxes in the Reagan Years</u>, we found that the median tax rate for the 250 large, profitable companies we examined was only 8.7 percent. Of the 250 corporations, more than half enjoyed at least one year between 1981 and 1983 in which they paid no federal income taxes or received tax refunds. A quarter of the companies paid no federal income taxes at all over the entire period, including giant firms such as General Electric, with $283 million in tax rebates on top of its $6.5 billion in pretax domestic profits; Boeing, with $267 million in rebates on top of its $1.5 billion

in profits; Dow Chemical, with $223 million in refunds on $776 million in profits; and Tenneco, with $189 million in refunds on $2.7 billion in earnings.

Back in the 1950s and 1960s, corporate income taxes paid for about a quarter of the cost of federal spending, other than the self-financed social security system. By 1984, corporate income taxes paid for less than 9 percent of federal spending other than social security.

The source of this striking decline in corporate taxes is the unparalleled growth in corporate and business "incentives" over the past 15 years, and most notably under the current administration. In 1970, the list of officially designated corporate "tax expenditures" totalled just $8.3 billion. For fiscal 1986, those provisions are estimated to amount to $119.9 billion--or $1.69 for every dollar estimated to be paid in corporate income taxes. Since 1970, the federal government has foregone $690 billion in revenues due to these "incentives." Including the interest paid to fund these tax breaks, the total addition to the national debt from these provisions since 1970 now stands at almost $1.2 trillion.



Source: Jt.Comm. on Taxation

Moreover, the same loopholes that have undermined the corporate tax have also fueled the proliferation of individual tax shelters. According to a Public Citizen study, such tax shelters are now costing the Treasury more than $24 billion annually.

It is precisely this growth in loopholes and the resulting decline in taxes paid by our most profitable corporations and our wealthiest citizens that has made the average taxpayer so angry and disgusted with the federal tax system. Back in 1972, before the loophole craze took hold, Americans told pollsters they considered the federal income tax the "fairest" of all the taxes they paid. Since 1979, however, as tax burdens on average citizens have risen, the federal income tax has been annually cited in the same polls as the "least fair tax" by more people than any other tax.

THE FAILURE OF CORPORATE AND BUSINESS TAX INCENTIVES

Over the years, as various corporate and business "incentives" were added to the tax laws, the promise was always made that they would lead to enhanced investment and economic growth. As more and more people are coming to realize, however, the loophole-based economic strategy has been a colossal failure. Despite the enormous cost of the tax breaks, the national savings and investment rate has not increased. In fact, looking at any long period since World War II, the savings and investment rate has been remarkably constant. From 1948 to 1965, it averaged 16 percent of the gross national product. From 1966 to 1973, it was also 16 percent of the GNP. And from 1974 to 1981, it remained at 16 percent of the GNP. Since 1981, national savings has averaged only 13.8 percent of the GNP, and despite a large influx of foreign capital, gross domestic investment has averaged only 15 percent of the GNP.

In January of this year, Citizens for Tax Justice released a study comparing investment behavior to tax rates for 238 of the nation's largest and most profitable nonfinancial corporations over the 1981-83 period. We found that the 50 companies that enjoyed the most tax incentives--and thereby enjoyed an average negative tax rate of minus 8.4 percent over the three years--actually reduced their capital spending by 21.6 percent between 1981 and 1983. In contrast, the 50 companies that paid the highest tax rates increased their investment by 4.3 percent--despite an average tax rate of 33.1 percent.

The facts that business tax incentives been ineffective at increasing investment and that they have added $1.2 trillion to the national debt are bad enough. But, in addition, the tax incentives have further damaged our country by distorting economic decisions. A 1981 Federal Reserve Board study, Public Policy and Capital Formation, for example, found that tax distortions had led to a "disturbing pattern of investment." It went on to note:

> "While finding that the overall rate of capital formation is probably adequate, this study concludes that the existing capital stock is misallocated, probably seriously, among sectors of the economy and types of capital, primarily because of distortions caused by inflation and U.S. tax laws. . . . The biases are substantial. . . . As a result, capital is not applied to its most efficient uses. . . . The cost to the nation has been lessened productivity growth and reduced business output."

At the same time, tax preferences have created a wave of tax shelters for upper-income individuals. Since 1979, syndicated tax shelters have quadrupled, diverting investment dollars into activities such as llamas, foreign stamps, already-built shopping centers, empty office buildings, and even a $485 million shelter in used billboards.

The claims of the loophole lobbyists that tax subsidies can somehow help improve our ability to compete in world markets have been proven false by years of experience. In fact, exactly the opposite is true. In its most recent study of corporate tax rates, the staff of the Joint Committee on Taxation found that American multinational corporations pay taxes to foreign governments on foreign profits at a rate more than triple what these companies pay to the U.S. Treasury on their U.S. earnings. Yet our position in world markets has continued to deteriorate. The time has come to face up to the fact that the loophole-based economic strategy has been a failure. American companies do not compete better abroad because they earn tax-sheltered profits at home. To the contrary, by diverting resources away from their most productive uses, the loopholes undermine our ability to compete. If America is to sustain and strengthen its international competitive position, it is imperative that we remove the distortions and irrationalities from our tax code.

We might learn a lesson here from the Japanese, who have basically stuck with the tax system the United States designed for them in the early 1950s. Year in and year out, Japanese corporate income taxes provide 25-30 percent of Japan's national revenues. A Congressional Research Service study found that the average effective corporate tax rate in Japan is close to 50 percent. The Japanese have maintained the revenues from their corporate tax and have avoided the economic distortions that we suffer under in the United States by eschewing tax loopholes. In 1983, Japanese corporations actually paid more in total income taxes than did American companies, despite the fact that Japan's GNP is only a third the size of ours. The reason was that while our tax laws provided $1.67 in corporate tax breaks for every dollar paid in corporate taxes that year, Japan's corporate "tax expenditure budget" amounted to only 2.7 cents for every dollar Japanese companies paid in income taxes.

Last year, the United Kingdom, which for many years has been victimized by a loophole-ridden corporate tax code similar to ours, decided to reverse course and repeal most of its "incentives." In announcing the program, the British Financial Secretary stated:

> "The UK system before Budget day offered probably the most generous tax subsidies in the world to certain types of investment. It was assumed that this would mean <u>more</u> and <u>better</u> investment in the UK than in competing nations. Yet this has not been the case. Disturbingly, the assumption that tax incentives meant better investment has been proved alarmingly wrong. There are many reasons why the UK has made poor use of capital but it is hard to escape the conclusion that a tax regime which subsidized and encouraged projects with low returns has been an important contributory factor."

To its credit, the Reagan administration's new tax plan does propose ending a number of corporate and business subsidy programs now embedded in the U.S. tax code. The investment tax credit would be repealed, a change that is expected to raise $171 billion over 5 years. Special tax dodges for defense contractors and others engaged in long-term contracts would be eliminated. Some of the preferences for banks and life insurance companies would be phased out. And significant reforms are proposed in the international area--designed to reduce tax subsidies that perversely encourage American companies to move offshore. We fully support these reforms, but we do not believe the program goes nearly far enough. Compared to the plan put forward by the Treasury Department last fall, the new administration program has scaled back its corporate reform provisions by 44 percent and has retained a number of costly and harmful tax preferences.

Although the President's proposal does call for a short-term increase in corporate taxes of about 22 percent, in the long run it entails only a token 9 percent corporate tax hike. Not only is this small increase insufficient as a matter of fairness, it also means that the President's plan is a long-term revenue loser. Since corporate taxes now constitute only one-sixth of federal income taxes, a 9 percent corporate increase cannot sustain the 7 percent long-term reduction in personal taxes that the program also entails. In addition, the administration's insistence on retaining a number of key business tax preferences has caused it to short change the middle class on tax reduction and to propose adding new inequities to the personal tax laws.

We think the Congress, starting with this Committee, can and must do better. By closing the corporate and business loopholes the administration has left open, the Committee can produce a tax bill that really restores the corporate income tax, that really eliminates the tax shelter industry, and that provides more tax relief to middle-income Americans in the bargain.

CHANGES NEEDED IN THE ADMINISTRATION'S PROPOSALS ON CORPORATE, BUSINESS, AND INVESTMENT INCOME

1. Depreciation:

The single most important reform in Treasury's November 1984 tax program was the proposal to repeal the Accelerated Cost Recovery System in favor of depreciation rules that required businesses to write off their machines and buildings as they actually wear out. The change is needed for a number of reasons, not the least of which is the enormous drain on the federal treasury that accelerated depreciation entails. Treasury estimated that its depreciation reforms would raise $213 billion over the 1986-90 period--more than a quarter of the total base broadeners in the package.

In addition, the current accelerated depreciation system is the most notorious distortion in what Treasury called an "irrational" system of business taxation. As Treasury put it:

> "The tax law provides subsidies to particular forms of investment that are unfair and that seriously distort choices in the use of the Nation's

scarce capital. The interaction of various provisions results in opportunities for tax shelters that allow wealthy individuals to pay little tax, create the perception of a fundamentally unfair tax system, and further distort economic choices."

Treasury went on to note: "The current [depreciation] system is obviously deeply flawed, since effective tax rates vary tremendously among asset types . . . . Moreover, by reducing effective tax rates below the statutory rate, the tax system favors investments in depreciable equipment and real estate over investments in labor and in inventories."

Notwithstanding this striking indictment of accelerated depreciation last November, the Reagan administration has now virtually abandoned its efforts at major depreciation reform. Instead of a system based on the way plant and equipment actually wear out, it proposes a new "Capital Cost Recovery System" that over the long term would actually be more generous than the current ACRS approach. Even in the short run, the new CCRS system would raise a mere $38 billion compared to ACRS between 1986 and 1990--an 80 percent reduction from the revenue estimated to be raised by the fair and accurate depreciation system proposed last fall.

For every class of depreciable property, the present value of depreciation write-offs under the proposed CCRS would be significantly larger than the present value of depreciation under ACRS. Total write-offs claimed on equipment in classes 1, 2, 3, and 5, which cover more than half of all corporate investment, would exceed those that would be taken under ACRS starting immediately and continuing in every year thereafter. The cost to the Treasury of write-offs for assets in class 4, which includes about one-third of all corporate investment, would exceed the cost under ACRS beginning in about 1992. Eventually, total depreciation taken on buildings also would exceed the amounts that would be allowed under ACRS.

As a result, the administration's CCRS approach would not produce a tax system under which corporations and businesses paid taxes based on their actual profits. Instead, CCRS would exempt approximately half the profits generated from equity-financed investments in depreciable equipment from tax. Coupled with full deductions for interest payments and other remaining tax preferences--and despite the adminstration's proposed token minimum tax--CCRS would inevitably allow many corporations to continue to pay very low rates of tax and it would produce a new range of tax shelters. The most important change that needs to be made in the administration's tax plan is to return to the kind of fair and accurate depreciation system proposed by the Treasury Department last fall.

2. Oil & gas:

In its November 1984 proposal, the Treasury Department proposed to eliminate the major loopholes for the oil and gas industry. At that time, Treasury announced that "[t]he goal of increased reliance on free-market forces underlies the Administration's energy policy." It noted that the current system of oil tax subsidies "encourages over-production of scarce domestic resources, adds complexity to the tax system, unfairly benefits owners of those resources, and erodes the perception of fairness of the tax system."

Treasury also answered those who claim that government subsidies to the oil industry are needed to promote national security. By eliminating distortions favoring the oil industry, said Treasury, tax reform would "encourage the development of alternative domestic energy sources . . . [and] encourage greater conservation, and that, plus less rapid depletion of domestic resources, would, over the long run, reduce vulnerability to foreign supply disruptions."

Now, however, the administration has abandoned its free-market stance on energy tax policy, in favor of continuing the drain-America-first approach that characterizes current law. Curiously, it now invokes "national security" for this perverse policy, making exactly the same arguments that Treasury refuted in its November program.

We believe that Treasury was right the first time. The tax preferences for the oil industry do indeed undermine tax fairness, distort economic decisions, and delay the country's needed transition to alternative energy sources and increased conservation. They should be repealed.

3. Capital gains:

Another major proposal in Treasury I was to end the special 60-percent exclusion for capital gains, while indexing capital gains for inflation. These two changes were expected to roughly cancel each other out in terms of total tax revenues. But they would affect different investors differently. For people with relatively modest real gains, indexing would usually be a better deal than the exclusion. In contrast, people with extraordinarily large capital gains reap a windfall from the 60-percent exemption.

A 1978 study by Martin Feldstein and Joel Slemrod found that replacing the exclusion with indexing would cut capital gains taxes substantially for taxpayers in the bottom half of the taxpaying population, but would increase them significantly for the wealthiest individuals.

The authors of the November Treasury proposal correctly noted that the capital gains exclusion is a primary force in creating tax shelters and causing harmful economic distortions. They also concluded that ending the exclusion would help promote productive investment and discourage wasteful paper shuffling.

Now, however, the administration wants to retain a 50 percent exclusion for capital gains, contending that it is needed to stimulate risky investments. Both the President and White House Chief of Staff Donald Regan have claimed that the 1978 reduction in the top capital gains tax rate from 35 to 28 percent was responsible for the recent venture capital boom. But there is little or no evidence to support this contention. The real boost to venture capital came from 1979 changes in the regulations governing pension funds, allowing them for the first time to get heavily into the venture capital market.

Fifty-nine percent of the increase in venture capital funds between 1978 and 1984 came from pension funds and other tax-exempt entities. Another 29 percent came from corporate investors such as banks and life insurance companies, which

(a) didn't see their capital gains tax rate reduced to any significant degree; and (b) don't pay much in taxes anyway. In other words, the venture capital boom was overwhelmingly dominated by organization for which tax "incentives" are irrelevant. Only 13 percent of the increase in venture money from 1978 to 1984 came from individual investors, the people affected by the capital gains tax cuts.

A recent Treasury Department study agreed that the capital gains changes did not provide any significant aid to venture capital. Not surprisingly, the study has been suppressed by the Reagan administration.

Even with no special exclusion, capital gains still enjoy the huge benefits of tax deferral until realization and total exemption when assets are passed on to heirs. We recommend that the administration's proposed 50 percent capital gains exclusion be scaled back or eliminated from the tax reform package.

4. Tax shelter reforms:

The abolition of accelerated depreciation, capital gains breaks, and oil loopholes, as suggested above and in Treasury's November program, would mean a real crackdown on tax shelters, both personal and corporate. In addition, further steps should be taken. Last fall, Treasury proposed to treat limited partnerships with more than 35 members as corporations, so that tax loss pass-throughs would no longer be possible for large syndicated shelters. We believe this provision, along with the tougher at risk rules proposed in Treasury I, should be reinstated in the tax bill and that the Committee should explore additional measures specifically directed at stopping tax shelters.

5. Other corporate base broadening recommendations:

We also recommend that the Committee:

o reject the administration's proposal to extend the research and experimentation credit;

o reexamine what appear to be overly generous transition rules for the reforms involving financial institutions;

o repeal the tax credit for Employee Stock Ownership Plans; and

o drop the proposal to index inventories. Indexing inventories might make some sense in a theoretically perfect system, but much inventory is financed by borrowing, and it is not fair to index inventory costs but not debt. Moreover, the administration's proposal to eliminate the LIFO conformity rule should be rejected. In fact, the conformity principle--which requires companies to follow the same rules for reporting to the IRS as they use in reporting to shareholders--should be extended wherever possible.

6. Corporate tax rates:

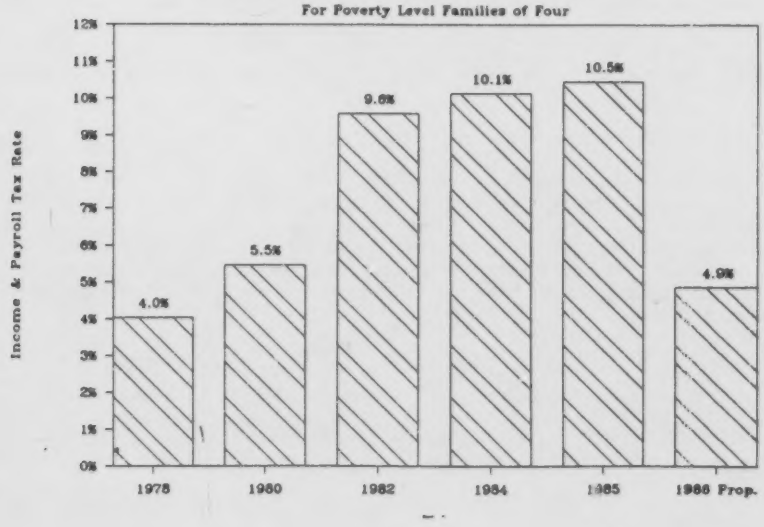
We strongly oppose the administration's proposal to reduce the corporate tax rate to 33 percent. Such a dramatic rate reduction--to a level far below the rate in most other major countries--is unjustified. It would in effect reward corporations for their lobbying successes in the past--lobbying that has been the key factor in producing our current unfair and economically harmful tax code. We believe that the corporate rate should be equal to the top personal tax rate, which, as described below, we believe should be at least 40-45 percent.

PERSONAL TAX CHANGES:

Two weeks ago, the President was asked to comment on the fact that his tax program would provide him personally with a tax cut of $28,000 a year. The President responded: "I think that just points out for everyone how advantageous the new tax system is." In fact, however, the President's huge projected tax savings from his program illustrates one of its basic defects. Average Americans are not clamoring for reform because they think the rich need a tax cut. Yet the President's program grants its largest tax reductions to the wealthiest Americans. The average individual earning more than $200,000 would save $10,000 a year in taxes under the Reagan plan. In percentage terms, the average cut of 10.7 percent for the very well-off is larger than for any income class except for the poor and near poor.

What's wrong with that? First of all, the rich already got their share and more of tax reduction as a result of the President's 1981 tax legislation. Individuals earning more than $200,000 received an average of $30,000 a year or more in tax reductions from the 1981 rate reductions and expanded tax avoidance devices. There is nothing even-handed about giving the rich additional large tax cuts, while short-changing the middle class and, for the poor, merely rolling back the tax increases that occurred during the President's first term.

Federal Income & Payroll Tax Rates



A second problem with the tax cuts for the rich is more subtle, but perhaps even more basic. The chief reason why taxes on the well-off have fallen so precipitously in recent years--from an effective rate of about 33 percent in 1978 to only 20 percent today--has been the sharp growth in "incentives" and tax shelters. But Congress did not enact those incentives for the purpose of cutting taxes for the well-off. Instead, they were adopted in the hope that they would help improve the general welfare, by stimulating the economy or diverting investment toward areas that seemed worthy.

The current thinking--with which we agree--is that the incentives have not been a success. To the contrary, they have distorted economic activity and resulted in significant waste of our economic resources. As a result, even the President, who championed the incentive approach in his first term, is advocating the elimination of many of these provisions.

Why, however, should the benefits of the repealed incentives be retained by the rich, who were never their intended beneficiaries in the first place? In effect, well-off investors were supposed to have been middlemen for the distribution of public benefits through the tax code. We have now discovered that these putative middlemen have siphoned off a large share of the benefits from the incentives--which is one reason why the incentives should be repealed. But that does not mean that the middlemen should keep their unjustified and unearned benefits in a reformed tax system.

We recommend that Committee adopt a personal rate structure with a top rate of at least 40-45 percent, perhaps for personal income in excess of $100,000. The rates and brackets should be structured to give greater tax relief to middle income families, while avoiding further tax cuts for the wealthy.

a. Deductions for state and local taxes:

The second largest "base broadener" in the administration's revised tax plan is the proposal to eliminate deductions for state and local taxes. In support of this change, the administration charges that the current system results in a "subsidy" from the citizens of low-tax states to the citizens of high-tax states, and that, in any event, the revenues from repealing deductibility are needed to pay for individual and corporate rate reductions.

We find the administration's arguments less than persuasive. Looked at as a substitute for a direct federal spending program, deductibility of state and local taxes arguably might appear inefficient or unwarranted. But, while it is frequently enlightening to compare incentive-type tax provisions to direct subsidies, such an analysis is not always appropriate. Consider, for example, the personal exemption. It is part of the tax code because it serves fairness goals, helping to exempt the poor from taxation and adding to progressivity. Yet, if one were to examine the personal exemption as a spending program, it would appear to be perverse. We do not hear the administration complaining, however, that, because the personal exemption is worth more to high-bracket taxpayers than those in low brackets, it is a "subsidy" from the poor to the rich.

Similarly, we think that the deductibility of state and local taxes is more appropriately analyzed on fairness terms, rather than as a subsidy. And, on fairness grounds, we think the deduction makes a great deal of sense. It is useful to compare the deduction for state and local taxes to the charitable

deduction, a provision that the administration tax program would retain. The fairness rationale for the charitable deduction is that money given away to charity shouldn't be considered part of an individual's taxpaying capacity. The individual doesn't get the benefit of spending or saving the money; instead the benefit accrues to a charitable organization, which presumably is engaged in activities that serve the public welfare. But at least individuals giving money to charity do so because they choose to. On the other hand, state and local taxes by definition go toward serving the public--and taxpayers are required to make those payments. Thus, if anything, the fairness case for allowing state and local taxes to be deductible is even stronger than the argument for the charitable deduction.

The idea that state and local deductibility makes sense in a fair tax system is not a new one. To the contrary, it has long been a fundamental tax policy principle. In its seminal tax policy paper, Blueprints for Basic Tax Reform (Jan. 1977), the Ford Treasury Department strongly defended the deduction for state and local taxes as a matter of fairness, and specifically rebutted the arguments now being made by the administration for eliminating the deduction. "[T]here is a strong equity case for allowing a deduction of [state and local taxes] in calculating individual income," Treasury stated in Blueprints. "These payments reduce the resources available to the payor for consumption or accumulation, and hence they are properly deductible."

Of course, as the administration points out, retaining the deduction for state and local taxes will require offsetting changes, both to recover the revenues involved and to avoid skewing the tax reductions even further in favor of the well-off. Under current law, the deduction for state and local taxes is worth $4,350 each to families earning between $100,000 and $200,000 a year and more than $13,000 each to families making over $200,000. To some degree, the cost of retaining state and local deductibility can be offset by further measures to close down tax shelters, as we have outlined earlier. In addition, however, it will also be necessary to increase tax rates, particularly at the upper-end of the income spectrum, from those proposed by the administration. In fact, to keep state and local deductibility--as we recommend--without a higher top individual tax rate would almost inevitably be a distributional disaster.

Tax Savings from Deductions for State & Local Taxes
Under Current (1985) Law

Income Class ($-000)	No. of Taxable Returns (000)	No. of Taxable Itemizers (000)	Amt. of S&L Tax Benefits ($-mill.)	Ave. per Taxable Itemizer	Ave. per Taxable Return
Under $10	17,033	818	$ 55	$ 67	$ 3
$10-20	24,396	4,309	891	207	37
$20-30	17,168	7,870	3,032	385	177
$30-40	9,899	7,111	4,695	660	474
$40-50	5,516	4,592	4,776	1,040	866
$50-75	3,513	3,217	5,315	1,652	1,513
$75-100	841	792	2,178	2,750	2,590
$100-200	707	674	3,075	4,562	4,349
Over $200	220	214	2,911	13,603	13,232
Totals	79,292	29,598	$26,928	$ 910	$ 340

Source: Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990 (Apr. 12, 1985).

b. Health insurance:

In its revised tax plan, the administration proposes to tax families on the first $300 per year they receive in employer-paid health insurance and to tax single individuals on the first $120. Apparently, the only serious rationale for this proposal is that it would increase taxes. In effect, the proposal acts to decrease the value of the administration's increased personal exemptions for workers with employer-paid health plans. As outlined earlier, we believe that there are far better ways to augment revenues than this proposal, and we recommend that it be dropped from the tax package.

CONCLUSION:

Tax changes over the past decade and a half, shifting the tax burden more and more onto average taxpayers and away from corporations and the wealthy, have created a deep public dissatisfaction with the tax system. We now have a rare opportunity to restore integrity, fairness, and economic common sense to our tax laws. The President's tax program--while deeply flawed--provides a starting point. With the kinds of changes we have proposed above, we believe that Congress can fashion a truly populist tax plan that will benefit the vast majority of Americans, help restore the public's faith in government, and stimulate economic growth. To do so, however, Congress will have to take on a variety of powerful interests and lobbies. We hope you will have the courage and the wisdom to do so.

Tax reform for the rich.

INSIDE THE SELLOUT

NOW THAT President Reagan has abandoned his brief flirtation with tax reform, it's time for Congress, starting with the House Democrats, to recapture the initiative. Reagan gave a fine television speech as always, telling the big corporations now snubbing their noses at the tax collector that "the free rides are over." But he didn't mean it.

Let's step back a moment from all the technicalities and ask what it is that has people so upset with the current tax system. Most of us believe the tax laws are rigged in favor of big corporations and wealthy individuals. Yes, people also think the tax code too complex, but our main objection to the complexity is that it creates unfair opportunities for manipulation. As the president put it in his speech, the tax code is "complicated, unfair, cluttered with gobbledygook and loopholes designed for those with the power and influence to hire high-priced legal and tax advisers."

Unfortunately, those with the power and influence to hire high-priced legal and tax advisers are exactly the ones who got the ear of the White House in the months between the Treasury Department's original reform plan last November and the president's speech May 28. What's more, a lot of the gobbledygook and the loopholes in the tax code are there because of Ronald Reagan's previous handiwork.

In his first term, Reagan nearly eliminated the corporate income tax with something called the Accelerated Cost Recovery System—a law that allows companies to write off the cost of buying new machines and buildings far faster than they actually wear out. This is the main reason General Electric and so many other hugely profitable companies no longer pay income taxes.

Reagan also gave the wealthy a huge tax cut in 1981—worth about $30,000 or more a year to families earning more than $200,000—by reducing the top individual tax rate from 70 percent to 50 percent and by adding a plethora of new tax-avoidance devices. The top rate on capital gains

was cut from 28 percent to 20 percent, a step that greatly pleased the average millionaire, who receives more income in the form of capital gains than wages. Ronald Reagan has presided over the biggest tax shelter boom in history. And during his watch federal taxes on the poor more than doubled.

Treasury's November 1984 tax program was in many ways a repudiation of Reagan's earlier policies. But the hopes that were raised by "Treasury I" have now been dashed. Let's take a close look at what it is Reagan is trying to sell to us as populist tax reform.

The single biggest reform provision in Treasury's November program was repeal of Accelerated Cost Recovery in favor of a system requiring businesses to write off their plant and equipment as it actually wears out. This change was expected to raise $213 billion in revenues over five years—about one-quarter of the total "base broadeners" in the original program. The reform was justified not just as a revenue raiser, but also because accelerated depreciation is the single biggest distortion of economic incentives in the tax code.

Reagan's new proposal virtually abandons the attempt to reform depreciation rules. In fact, it would actually increase depreciation write-offs over the long term. In the short run, the new depreciation rules would raise about $39 billion over five years—an 80 percent cut from the original program.

Another major proposal in Treasury I was to end the special break for capital gains, while indexing the measure of gains for inflation. These two changes were expected to roughly cancel each other out in terms of total tax revenue. But they would affect different investors differently. People who held assets for a long time would usually find the inflation indexing a much better deal than the current 60 percent exclusion. Conversely, people who are constantly trading stocks and bonds—generally the wealthiest capital gains recipients—wouldn't get much help from indexing. The authors of Treasury I correctly noted that the capital gains exclusion is a primary force in creating tax shelters and causing harmful economic distortions. Switching to indexing would encourage productive investment and discourage wasteful paper-shuffling.

NOW, HOWEVER, the administration wants to retain a 50 percent exclusion for capital gains, contending that it's needed to stimulate risky investments. Both Reagan and White House Chief of Staff Donald Regan are fond of crediting the recent venture capital boom to the 1978 and 1981 reductions in capital gains taxes. Venture capital has indeed surged since 1978. But there is no evidence to support this *post hoc, ergo propter hoc* reasoning. The key factor was a change in the regulations governing pension funds, which aren't affected by tax incentives since they aren't taxed. Fifty-nine percent of the increase in venture capital funds between 1978 and 1984 came from pension funds and other tax-exempt entities. Another 28 percent came from corporate investors such as banks and life insurance companies, which (a) didn't see their capital gains rate reduced to any significant degree; and (b) don't pay much in taxes anyway. Individual investors, the people affected by the capital gains tax cuts, supplied only 13 percent of the 1978-84 increase in venture capital.

A recent Treasury Department study concluded that the capital gains changes did not provide any significant boost to venture capital. Not surprisingly, the study has been suppressed by the Reagan administration.

IN THE OIL and gas area, Treasury's November 1984 proposal would have raised $39 billion over five years by ending the notorious percentage depletion allowance and another special rule allowing an immediate write-off for the cost of drilling wells. Reagan's latest plan junks these reforms, except for a phased-in limit on percentage depletion in some cases. It would raise only four billion dollars from oil and gas over the same five years. Helping persuade Reagan that "national security" requires keeping the oil loopholes was an absurd coalition of independent oil producers and Jewish tax shelter promoters supposedly concerned about the welfare of Israel.

The abolition of accelerated depreciation, capital gains breaks, and oil loopholes, as Treasury I proposed, would have meant a real crackdown on tax shelters, both personal and corporate. As a backstop, Treasury proposed to treat large limited partnerships as corporations, in order to foil large tax shelter syndications. In the new plan, however, that rule has been dropped, another step that should cheer the oil tax shelter promoters. Real estate tax shelters also would survive, mainly because of the continuation of fast depreciation. Although real estate shelter promoters are wailing about some limited restrictions on their activities in the tax bill, they have told *The Wall Street Journal* that they "think there are going to be a lot of ways to get around" any problems the tax bill might create.

So what's left of tax reform in Reagan's program? Well, a few good features. The investment tax credit would still be repealed, a step that raises $170 billion over five years and is now the biggest reform in the package. Special dodges for defense contractors and other businesses engaged in long-term contracts would be eliminated. Some of the preferences for banks and life insurance companies would be scaled back—although Treasury I's $54 billion in added revenues from financial institutions over five years was cut to only $23 billion in the new package. And significant reforms in the international area—designed to reduce tax subsidies that perversely encourage American companies to move offshore—have been retained. Overall, however, the $767 billion worth of loophole closing in the original package has been cut way back, primarily by a 44 percent scale-back in the corporate reforms.

Looming especially large in the new package is the proposal to end personal deductions for state and local taxes. This is now the second largest revenue-raising item in the plan and the one on which the administration says it is least willing to compromise. Yet deductions for state and local taxes are hardly at the heart of what's wrong with the tax code. Up till now the arguments both for and against

the deduction for state and local taxes have seemed notably unenlightened. Whichever case you hear last comes close to persuading you that the other side must be right. Officials from high-tax states have complained—often with an excess of hyperbole—that ending the deduction would be a financial catastrophe, that all their rich citizens would move out, and that their states are being singled out for unfair treatment. Reagan administration officials have retorted that they need to repeal the deduction in order to finance the tax rate reductions, and have added that if high-tax states in the Northeast suffer, it serves them right.

CONSIDER, though, that the administration bill would retain the deduction for charitable contributions. The rationale is that money given away to charity shouldn't be considered part of an individual's taxpaying capacity. The individual doesn't get the benefit of spending or saving the money; instead the money accrues to charities, which presumably are providing benefits of a public nature. That's a pretty good argument. But at least people who give money to charity do so because they choose to. State and local taxes by definition go toward serving the public—and taxpayers are *required* to make those payments. It's hard to see why state and local taxes shouldn't be deductible if the write-off for charitable donations makes sense.

Donald Regan has described Reagan's proposed individual rate structure—15 percent, 25 percent, and 35 percent—as having "a nice symmetry." But when Social Security taxes and capital gains preferences are factored in, that symmetry disappears. For families of four earning up to about $40,000, the marginal tax rate, including the 14 percent Social Security tax on wages, comes to 29 percent. From $40,000 to about $80,000 or so, the rate drops to 25 percent (because Social Security taxes no longer apply). At the upper levels, a 35 percent tax rate applies to wages. But the top marginal tax rate on the most common type of income enjoyed by the very wealthy—capital gains—is only 17.5 percent, since half of capital gains would be excluded from tax. So the real rate structure is: 29-25-35-17.5. Not very symmetrical.

So is Reagan right when he claims that almost everyone will win from his program? Well, the plan *is* good for the poor, at least in the short run. The proposed increase in the zero-bracket amount, the personal exemption, and the earned income tax credit will roll back most of the tax increases on the poor that occurred during Reagan's first term. For the rich, however, the plan is even better. By proposing a further dramatic drop in the top tax rate, keeping the capital gains preference, and retaining many of the favorite tax shelters of the well-to-do, Reagan's program would result in another $10,000-a-year average tax cut for those making more than $200,000. In other words, the big winners in Reagan's earlier tax policies are the same big winners in his latest proposals.

For those who fall somewhere between rich and poor, the results are more of a mixed bag. On average, middle-income taxpayers would receive the smallest percentage reductions in their taxes of any income group. Families earning between $20,000 and $50,000 would get average tax cuts of about $160 a year. Those who currently don't itemize deductions or who have large families may do better than that. But those itemizers who pay a lot in state and local taxes may be headed for a tax increase.

Overall, personal taxes are projected to decline by about five percent by 1990. What's supposed to make this possible is a projected 22.5 percent increase in corporate tax collections. That appears to add up: since corporate income taxes are now only one-sixth of total income taxes, every one percent cut in personal taxes must be balanced by a five percent increase in corporate taxes. But because Reagan has restored many of the most important corporate loopholes, much of the administration's new corporate tax revenue would come from temporary gimmicks, such as a recapture of previous accelerated depreciation write-offs.

Ultimately, the Reagan plan is projected to increase corporate taxes by only a token nine percent. Given that effective corporate tax rates were cut in half in Reagan's first term, this isn't much at all. Moreover, it turns Reagan's plan into a big revenue loser in the long run. A nine percent rise in corporate taxes simply can't sustain the seven percent long-term cut in individual taxes the program also calls for.

If the Reagan plan is indeed a revenue loser, then its enactment could exacerbate our already serious deficit problems. And bigger deficits will mean bigger budget cuts, higher interest rates, or higher taxes down the line. Higher taxes could mean that even the modest tax cuts for the middle class, as well as the changes benefiting the poor, could be in danger in the future.

Despite some good points, the Reagan tax program is at bottom not even close to real tax reform. It continues previous policies favoring the rich, fails to redress the imbalance between individuals and corporations, and does not deliver the knockout blow to tax shelters that the country desperately needs to sustain long-term growth. If Congress wants to design a truly fair tax program, it must find the political courage to take on the special interests with which Reagan has chosen to ally himself. The key elements in a real reform package should be serious depreciation reform (as the Treasury proposed last fall), taxation of oil and gas profits and of capital gains just like other income, and less sweeping reductions in the corporate and top individual tax rates. This short list of changes—to which many smaller ones could be added—would raise several hundred billion dollars over the next five years. That's enough to pay for a lot more relief for average taxpayers—whether in the form of lower taxes, reduced deficits, or both—than President Reagan is now offering.

ROBERT S. MCINTYRE

Robert S. McIntyre is director of federal tax policy at Citizens for Tax Justice.

OUTLOOK

Commentary and Opinion

Disarm the Deficit: End Corporate Tax Dodges

By Robert S. McIntyre

THERE IS REALLY only one sensible way to deal with the huge budget deficits that hang over the American government and economy like an undetonated bomb, and that is to raise taxes on American corporations — not in any radical way, but just to something like the levels of taxation that prevailed during the last great American boom, in the 1960s.

The facts are simple: In the '60s, when the economy and capital investment were both growing at record rates, taxes paid by American corporations covered the cost of about one-fourth of all government spending other than Social Security (which is self-financed by its own tax). By last year corporate taxes financed just 8.8 percent of government spending on all programs other than Social Security. Ironically, some of our most dynamic firms still pay significant taxes. IBM, for instance, pays a tax rate of close to 30 percent on its profits. But many other corporate giants now pay no corporate income tax *at all*, thanks to loopholes and incentives enacted since 1970.

If every corporation again paid taxes at the level they paid in the '60s, the budget deficit would instantly be cut in half. We could expect interest rates to fall, the dollar to return to a more sensible value, and the economy to prosper without the dangerous imbalances that now threaten our future.

Is this politically impossible? No. Despite President Reagan's attempts to make any tax increase sound like sedition, even the most antitax of America's politicians agree that something needs to be done about corporate taxes. Three weeks ago, Rep. Jack Kemp (R-N.Y.) got big cheers from the participants at the 12th annual Conservative Political Action Conference when he said: "There is no reason conservatives should support tax breaks and subsidies for corporations. There's no reason for corporations to be subsidized by government."

But today they are subsidized to a degree most citizens don't realize. For every dollar corporations paid last year in taxes, loopholes allowed firms to avoid $1.42. In other words, the current corporate tax provides 40 percent more in subsidies than in revenues — $90-100 billion in subsidies in the current fiscal year.

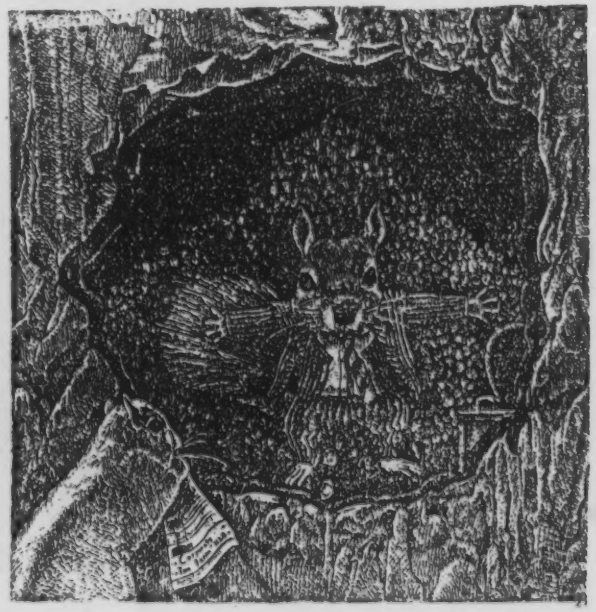
Even the Reagan administration has figured out the problem. In late February, newly appointed Treasury secretary, James Baker, told the House Ways and Means Committee that "there's no way to make the tax system *fair* to individuals without raising business taxes. It's that simple." And most important, at a recent press conference, President Reagan himself indicated a willingness to raise corporate taxes, at least on those corporations "who are not now paying taxes at all or paying very low taxes."

Last October, Citizens for Tax Justice, a coalition of citizens' groups and labor unions, released a study documenting just how many corporations fit into the category the president thinks should be paying more in taxes. Of the 250 large, profitable companies we surveyed, more than half enjoyed at least one year between 1981 and 1983 in which they either paid zero in federal income taxes or actually received cash rebates from the Treasury.

A quarter of the firms paid a total of nothing or less over the full three years.

See TAXES, C8, Col. 1

Robert McIntyre is director of federal tax policy at Citizens for Tax Justice.



BY STEVE HEDEDUSEN — THE WASHINGTON

End Corporate Tax Dodges

TAXES, From C1

The overall tax rate for the 250 corporations was only 14 percent, and virtually all of that was paid by just a handful of the companies. The 200 lowest-taxed firms paid a mere 4 percent of their profits in federal income taxes.

Topping the list of corporate freeloaders was General Electric, which paid not a penny in taxes on its $6.5 billion in domestic profits in 1981-1983. Instead, GE received $283 million in outright tax refunds — checks written by the Treasury to the company rather than the other way around.

Next came Boeing, with $267 million in tax rebates on top of $1.5 billion in earnings. Boeing's case typifies the defense industry's disdain for helping pay for the arms buildup from which it is profiting. Seven of the top 11 defense contractors — all of them highly profitable firms — including the much-criticized General Dynamics, paid zero in taxes or got money back from the government over the three years.

W.R. Grace & Co., despite its $684 million in profits, made $12.5 million off the tax system by selling its excess tax breaks — an example of government waste that went unmentioned in the Grace Commission's report.

It is conventional wisdom that "out-of-control" federal spending is the source of the deficit. But while a few areas of spending, notably defense, have been increasing rapidly in recent years, corporate nonpayment of taxes is by far the most critical factor in the deficit calculus.

A look at 1960s helps explain what has happened. Supposedly the period when spending got out of hand, the '60s actually were distinguished by being the only decade in this century that both began and ended with the budget in balance.

How was this feat achieved? Well, it certainly wasn't because we spent a lot less of our money on government programs in the old days. In 1960, for example, before the advent of the New Frontier and the Great Society, federal spending for everything except Social Security and interest on the national debt amounted to 14.9 percent of the gross national product. In 1984, that share had hardly changed — totaling 15 percent of the GNP.

And we can't blame our current horrendous deficits on Social Security. Although it has grown since the '60s, Social Security payroll taxes take in more than the program spends, and the Social Security surplus is expected to get larger over the next decade.

Here's the crucial difference: In 1960, corporate income taxes paid for 26.3 percent of federal spending other than Social Security. But by fiscal 1984, the corporate share had plummeted to only 8.8 percent. As a percentage of GNP, corporate income taxes fell from 4.3 percent in 1960 to 1.6 percent in 1984.

The loopholes that make possible corporate tax avoidance have also fostered the creation of tax shelters that have enabled wealthy individuals to escape paying billions in federal taxes. In a study published by Public Citizen, the Ralph Nader organization, Richard Meyer estimates that such tax shelters are now costing the Treasury more than $24 billion annually, a number that is growing rapidly, despite supply-siders' claims that the 1981 cuts in tax rates for the rich would "eliminate" shelters.

Moreover, the enormous amount the federal government now pays in interest — up from 1.4 percent of the GNP in 1960 to 3.1 percent in 1984 — has its roots in government borrowing to fund corporate tax reductions over the past 15 years. In sum, had corporate tax payments not fallen off since the 1960s, we would have no deficit today.

Individual citizens have a right to be angry at the tax system. In 1960, their taxes produced less than twice as much revenue as the corporate income tax. By 1984 individuals were paying more than five times as much as corporations.

What are these loopholes that are wreaking such havoc on the tax laws and the nation's finances? There are many, but two in particular dominate. The first is the Accelerated Cost Recovery System, enacted in 1981 at the behest of the Reagan administration, which allows companies and tax shelter investors to "depreciate" machinery and buildings far, far faster than they actually wear out. Accelerated depreciation permits a company buying a new machine tool costing $100,000, for example, to deduct its full cost from its taxable profits over 4½ years. But the average machine tool lasts 10 years or more.

The second megaloophole is the investment tax credit, which provides 10 cents in tax reduction for every dollar spent on equipment. In other words, that same hypothetical company could cut its tax payment by an additional $10,000 in the year it bought that new machine tool.

Without these two loopholes, General Electric, for example, would have paid close to $1 billion in taxes in 1983, instead of receiving a refund. Altogether, the cost of accelerated depreciation and the investment credit comes to a staggering $65 billion in the upcoming fiscal year, and is expected to exceed $121 billion annually by 1990.

It doesn't take a wild-eyed radical to see the importance of these loopholes. President Reagan's own Treasury Department understood their significance in the "tax simplification" plan it advanced last November. Drafters of the Treasury plan recognized that to make taxes simpler, fairer and lower for individuals, they had to recoup this money now given away to corporations.

Of the $767 billion that Treasury's 108 separate reform provisions would raise over five years, $371 billion comes from repealing the Accelerated Cost Recovery System and the investment tax credit. Another $149 billion would come from eliminating special breaks for oil companies, defense contractors, financial institutions and companies that moved their plants abroad. Thus two-thirds of Treasury's reform program centers on closing corporate and tax-shelter loopholes.

Unfortunately, the Treasury plan would use the new revenues raised by a more comprehensive corporate tax simply to lower tax rates for companies and individuals. Treasury would shift $40 billion in taxes from individuals to corporations by 1990, but overall, in the jargon of the tax business, the proposal is "revenue neutral" — it does nothing to give the Treasury more money to close the yawning budget deficits.

But a reform program that does nothing to reduce the deficit makes no sense. Eventually, it would have to be followed by higher rates or new taxes — perhaps the national sales tax or "value added tax" backed by some corporate lobbyists. But such taxes are unfair; Treasury says that a 10 percent national sales tax would add about 50 percent to the income tax bills paid by families earning $40,000, and could triple taxes for families making $10-15,000. Wealthy indviduals would face only an 8 percent tax hike, and corporations would be exempted entirely from such a sales tax.

There is a better way. Rather than use all the money raised by tax reform to cut tax rates and end up with corporations paying only 12 or 13 percent of the federal tax burden, as under Treasury's plan, we ought to tie tax reform and deficit reduction together. If, for example, Congress were to adopt Treasury's entire reform package except for Treasury's corporate rate reductions and another proposal for dividend tax relief, the program would raise $280 billion over five years. Individuals would still get tax cuts, but by 1990 the deficit would be $100 billion a year less.

Such a change would require corporations to bear about 19 percent of the federal tax burden. This is not so onerous. In the booming '60s our corporations paid considerably more than that, and our successful com-

petitors in Japan raise nearly 30 percent of their national revenues from corporate income taxes.

Corporate lobbyists argue that raising corporate taxes will only result in higher prices for consumers, since "companies don't pay taxes, people do," in one of the lobbyists' favorite phrases. But this claim is not defensible. An example: the profitable Whirlpool Corp. paid almost 46 percent of its profits in taxes in the '81-'83 period, while its competitor, General Electric, paid no taxes at all, and actually got hundreds of millions in tax refunds from the Treasury. But Whirlpool washing machines — higher rated than GE's by consumer testing organizations — are cheaper than GE's.

Another example: In 1983, Exxon paid 34 percent of its profits in taxes; Mobil paid 6 percent; Texaco got a tax refund. Has anyone noticed dramatic differences in the price of the gasoline each sells at the pump?

If corporations can easily pass on taxes to their customers, you wouldn't think they'd mind paying taxes so much. But even the modest increase in corporate taxes proposed by the Treasury Department has the loophole lobbyists screaming like stuck pigs. They claim it would hurt the economy to close loopholes and ask corporate tax-avoiders like General Electric to pay their fair share of the costs of government. In fact, however, tax reform would help the economy immensely.

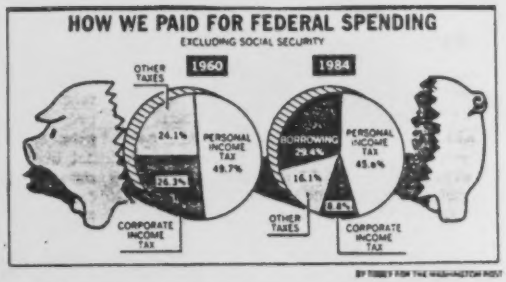
The evidence is overwhelming that "tax incentives" have been a colossal failure as an economic strategy. The lobbyists promised that the loopholes would increase business investment and produce a healthier economy. But that did not happen.

"The taxation of capital and business income in the United States is deeply flawed," the Treasury tax plan states. "It is best characterized as irrational. . . . The tax law provides subsidies to particular forms of investment that are unfair and that seriously distort choices in the use of the nation's scarce capital."

Proponents of tax breaks for business investment have argued that these incentives were needed to encourage our companies to make the investments needed to compete effectively against the Japanese and other foreign competitors. But as the Treasury points out, the incentives actually encouraged unproductive activities at the expense of productive investment.

Tax incentives "work" only in the sense that they encourage investments that make no economic sense. The glut of office construction in many of our cities is one example of the kind of waste that tax incentives create. So is the wild proliferation of tax shelters in everything from llamas to foreign stamps to embryonic cattle breeding to used shopping centers and even billboards.

Despite the enormous expansion in corporate loopholes in the 1981 Reagan tax bill, after it took effect, total investment in plant and equipment (measured in constant dollars) declined for three straight years. Instead of an investment-led boom promised by the tax cut's proponents, we got the worst recession since the 1930s. Investment boomed in the recovery year of 1984 — but in response to surging consumer demand, not to the incentives contained in the 1981 tax bill. Overall, the increase in business investment in Reagan's first term was considerably less than during Jimmy Carter's presidency.



Most tellingly, the companies in our Citizens for Tax Justice study enjoying the largest "incentives," such as G.E., Boeing and W.R. Grace, cut their investment the most between 1981 and 1983. The companies paying the highest taxes bucked the national trend and increased their investment. Whirlpool — while paying 46 percent of profits in taxes — increased its capital spending by 7 percent; IBM, despite a 28 percent tax rate, increased investment by 15 percent.

The Treasury's tax-reform plan contains another overdue change — an end to the tax break for "capital gains," or profits from the sale of investments held for more than six months. Here again the loophole lobbyists make eloquent but false claims for the "success" of a tax break that actually had no positive consequences, but did spur tax shelters and undermine tax fairness.

The lobbyists insist that 1978's reduction in the top capital gains tax rate from 35 to 28 percent was responsible for the boom in venture capital that began in 1980. "The problem with this argument," Michael Barker pointed out recently in the newsletter Politics & Markets, "is that there is nothing to it — no evidence that it is true, and considerable evidence that it is not." The key factor behind the increase in venture capital, Barker notes, was a change in the rules governing pension funds, allowing them for the first time to get heavily into the venture-capital market, where investors can put money into new and often risky business ventures.

Barker's conclusion is borne out by data recently published in Venture Capital Journal, an expensive publication for the finance industry, showing that 87 percent of the increase in venture capital between 1978 and 1984 was supplied by pension funds, other tax-exempt entities and quasi-tax-exempts, such as life-insurance companies and banks. In other words, the venture-capital boom was overwhelmingly dominated by organizations for which tax "incentives" are irrelevant, since they don't pay taxes anyway.

Even the corporate lobbyists' computer models are betraying them. Recently, the National Association of Manufacturers commissioned Wharton Econometrics to analyze Treasury's tax program on its model of the economy. Wharton's computer model is programmed to conclude that tax incentives produce higher investment, so it predicted that the Treasury reform would reduce "capital formation." But the model also concluded that enactment of Treasury's reforms would lead to greater employment, increased consumer spending, a reduced federal deficit and a higher GNP.

The power of the case for repealing corporate loopholes appears to be sinking in even for President Reagan, although it has taken a while. When he first looked at Treasury's proposals, the president was quite cool to the idea that virtually everything he had ever stood for when it came to taxes was wrong. In his State of the Union address, the president praised the "principles" of Treasury's plan, but explained that he favored closing loopholes "while maintaining incentives."

Compounding the confusion, Reagan went on to repeat his past calls for still more tax loopholes. A week later, the president told The Wall Street Journal that the basic thrust of Treasury's reform plan — raising corporate taxes and cutting taxes for individuals — was a "detail" he wasn't familiar with.

Since then, however, the president has made a breakthrough. By admitting the possibility of raising taxes on those corporations "who are not now paying taxes at all or paying very low taxes," he has made it clear that his 1984 pledge of no tax increases applied only to individuals. The door is now open for combining tax reform with deficit reduction. If Congress is at all concerned with cutting the deficit and making the tax system fair, it should rush in.

ROBERT S. McINTYRE and
DEAN C. TIPPS

Exploding the Investment-Incentive Myth

Corporate tax breaks haven't spurred investment: of 238 firms studied, the lowest-taxed reduced capital spending at above-average rates in 1981–83, while the highest-taxed hiked their outlays.

The federal corporate income tax is but a loophole-riddled shadow of its former self. Back in the 1950s and 1960s, it contributed a quarter of all federal revenues. By 1983, its share had dropped to 6.2 percent, with loopholes reducing corporate tax revenues by $1.67 for every dollar actually collected. The largest loophole of all is the Accelerated Cost Recovery System (ACRS), a system of super-accelerated write-offs for business investments in plant and equipment, enacted as part of the 1981 Reagan tax bill. Together, ACRS, the investment tax credit, and other corporate loopholes now cost the federal government more than any program in the budget except defense and Social Security, and far more than all federal programs for the poor combined.

In October 1984, Citizens for Tax Justice released a study of the impact of ACRS and other corporate loopholes on the taxes paid by 250 major U.S. corporations from 1981 through 1983. The study found that the 250 companies paid an overall federal income tax rate of 14.1 percent on domestic profits totaling $291.4 billion, making a mockery of the statutory 46 percent corporate tax rate; this legal tax avoidance added $91 billion to the federal deficit over the three years.

Seventeen companies with a total of $14.9 billion in profits paid no federal income taxes in each of the three years, and claimed tax benefits totaling $1.2 billion through rebates of taxes paid before Reagan took office or from the sale of excess tax breaks to other companies. Sixty-five companies with a total of $49.5 billion in pretax profits paid zero or less when their federal income taxes were totaled for the three years 1981–1983, receiving outright tax subsidies that brought their after-tax profits to $3.2 billion *more* than they made before taxes—a "negative" tax rate of −6.5 percent. And 128 companies paid zero or less in taxes in at least one of the three years, claiming an additional $5.7 billion in tax benefits on top of the $57.1 billion in pretax profits they earned during the years in which they paid no taxes.

This massive corporate tax avoidance is an affront to every taxpayer. It shifts more of the tax burden onto middle- and low-income wage earners and enlarges the federal deficit. But the corporate lobbyists whose job it is to add loophole after loophole to our tax code always have an answer. What most people call loopholes, they call "incentives." Without these incentives, they argue, businesses won't be able to expand

ROBERT S. McINTYRE is director of federal tax policy and DEAN C. TIPPS is executive director of Citizens for Tax Justice in Washington, D.C.

their investment; this will undermine economic growth and our competitiveness in the world economy.

This argument has served the loophole lobbyists well, as officially designated corporate "tax expenditures" have grown from $7 billion in 1970 to over $100 billion in the upcoming fiscal year. What politician wants to go on record against investment, growth, and competitiveness in the world economy? Surprisingly, however, after the "incentives" enter the tax code, no one seems very interested in finding out if they actually result in the increased capital spending promised so persuasively by the lobbyists. Each year, the federal government forgoes tens of billions of dollars in corporate tax revenues in the name of encouraging greater business investment without holding either the lobbyists or their corporate employers accountable if the additional investment fails to materialize.

We have now studied the investment patterns of 238 profitable nonfinancial corporations between 1981 and 1983 and found that the corporate claims about tax "incentives" are dead wrong. The truth is that companies with the lowest taxes reduced investment at above-average rates, while the highest-taxed companies actually increased their investments.

Table 1 **Corporate Tax Rates, Investment, and Dividends, 1981–1983**

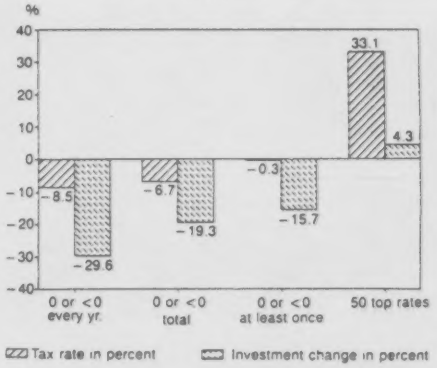
	Average tax rate (in %)	% change Investment (in %)	% change Dividends (in %)
50 corporations with the lowest tax rates	−8.4	−21.6	+14.1
50 corporations with the highest tax rates	+33.1	+4.3	+10.7

Corporate tax breaks spur dividends, not investment

As Table 1 indicates, the fifty lowest-taxed nonfinancial corporations in our study had an average tax rate over the three years of −8.4 percent. Yet, despite all the "incentives" they took advantage of, they *reduced* their investment by 21.6 percent. By contrast, the fifty corporations with the *highest* tax rates *increased* their investment over the same period by 4.3 percent, while paying 33.1 percent of their profits in federal income taxes. Interestingly, while cutting back on new investment, the low-tax companies also increased their dividends at a pace more than 30 percent greater than the high-tax companies.

Evidence is overwhelming that the billions of dollars the federal government spends each year on tax incentives to encourage investment have failed to achieve their purpose. Consider the following findings, as shown in Figure 1:

Figure 1 **Tax Rates and Changes in Investment (1981 to 1983, by tax category)**



• The fifteen nonfinancial companies in our study that paid zero or less in taxes each year for three consecutive years (i.e., they did better than zero by claiming rebates of taxes paid in earlier years or selling excess tax breaks to other companies) *reduced investment by 29.6 percent* from 1981 to 1983, while increasing dividends by 9.5 percent. These companies paid *no* taxes on $14.1 billion in profits and claimed tax benefits of $1.2 billion, for a tax rate of −8.5 percent.

• The fifty-eight nonfinancial companies in our study that paid a total of zero or less in total taxes over the three years *reduced investment by 19.3 percent* from 1981 to 1983 and increased dividends by 17.6 percent. These companies earned $47.4 billion in profits and claimed $3.2 billion in tax benefits, yielding a tax rate of −6.7 percent.

• The 118 companies in our study that paid zero or less in at least one of the three years *reduced investment by 15.7 percent* from 1981 to 1983 while increasing dividends by 21.2 percent. These compa-

51-219 O - 86 - 2

nies joyed a tax rate for the period of −0.3 percent.

Each of the five companies claiming the largest tax rebates over the three years increased its dividends while reducing investment. General Electric earned $6.5 billion in profits over the three years, paid nothing in taxes, and claimed rebates of taxes paid before Reagan took office totaling $283 million. Despite taking full advantage of all the investment incentives in the federal tax code, however, GE actually reduced its level of new investment by 15 percent from 1981 to 1983 while increasing its dividends by 19 percent.

The four other high-rebate companies followed the same pattern: Boeing ($267-million rebate) reduced investment by 59 percent, Dow Chemical ($233-million rebate) by 46 percent, Tenneco ($189-million rebate) by 32 percent, and Santa Fe Southern Pacific ($141.7-million rebate) by 21 percent. As Table 2 indicates, these five companies slashed their rate of new investment by 29.8 percent while increasing dividends to their shareholders by 11.8 percent. Together, the five earned $13.1 billion in profits, paid nothing in taxes, and gained $1.1 billion in tax rebates, for a negative tax rate of −8.4 percent.

The study revealed many other examples of corporations taking full advantage of available tax incentives while reducing investment and increasing dividends:

• Union Carbide earned $613 million in profits, paid no taxes, and claimed net tax benefits of $70 million (a −11.4 percent tax rate), yet it reduced investment by 35.8 percent and increased dividends by 7.1 percent.

• Pacific Power and Light, with a −3.7 percent tax rate on $598 million in profits, reduced investment by 20.7 percent and upped its dividends by 26 percent.

• CSX Corporation enjoyed a −0.9 percent tax rate on its $1.8 billion in profits, yet it reduced new investment by 38.4 percent while raising dividends 18.4 percent.

• AT&T paid only 1.1 percent of its $31.4-billion profit in federal income taxes, yet it reduced its new investment by 21.9 percent while raising dividends 28.6 percent.

• Sperry Corporation paid taxes of only 0.5 percent on its $607.9-million profit, reduced new investment by 26.8 percent, and increased its dividend payments by 20.1 percent.

• Panhandle Eastern Corp. slashed its investment by 64.9 percent while adding 19.7 percent to its dividends, despite a tax rate of −3.1 percent on its $938 million in profits.

In sharp contrast, Whirlpool Corporation—the highest-taxed company in the study, paying 45.6 percent on profits of $650.2 million—*increased* its new investment by 7 percent. The study revealed many other examples of relatively high-tax companies which have increased their investment:

Table 2 **Changes in Investment and Dividends by the Five Corporations Claiming the Largest Tax Benefits Between 1981 and 1983**

	Profits (billions of dollars)	Tax rebates (millions of dollars)	Tax rate (in %)	% Change	
				Investment	Dividends
General Electric	6.527 0	−263 0	− 4 3	−15 0	+19 2
Boeing	1.530 0	−267 0	−17 5	−59 1	+ 0 7
Dow Chemical	776 0	−223 0	−28 7	−46 4	+ 2 9
Tenneco	2.687 0	−189 0	− 7 0	−31 8	+12 9
Santa Fe Southern Pacific	1.579 0	−141 7	− 9 0	−21 4	+ 4 2

• IBM paid a 28.2 percent tax rate on its $14.1-billion profit while increasing investment by 15.3 percent.

• Exxon paid 27.5 percent on profits of $9.4 billion while increasing investment by 26.4 percent and *cutting* dividends by 3 percent.

• ABC paid 38.7 percent on profits of $818.7 million while increasing investment by 133.1 percent and dividends by 3.1 percent.

• R. J. Reynolds Industries paid 40.3 percent on its $3.4 billion in profits, yet it managed to raise investment by 34.1 percent.

Overall, the 238 nonfinancial companies included

in our study had an effective tax rate from 1981 through 1983 of only 14.3 percent, far below the 46 percent statutory corporate tax rate on income over $100,000. In exchange for the reduced effective tax rates made possible by ACRS, the investment tax credit, and other tax "incentives," these companies reduced new investment by 15.5 percent and raised dividends by 17.0 percent.

Adjusted for inflation in plant and equipment prices, investment by the 238 firms fell by 17.6 percent between 1981 and 1983. Thus, these major corporations had an even worse investment performance than did the overall economy, in which plant and equipment spending fell by 8.8 percent in constant dollars over the same period. But the overall national experience is bad enough. Contrary to the claims and promises of the loophole lobbyists, as the cost of loopholes skyrocketed, real business outlays for plant and equipment fell. In fact, they fell in each of the first three years the investment "incentives" in the 1981 Reagan tax bill were in effect—the first such three-year decline in the postwar era. Even with the rebound in 1984, the four years under the much-touted ACRS have been pathetic ones for capital spending, and the record stands in sharp contrast to investment performance in the four years before ACRS was enacted (see Table 3 and Figure 2).

Table 3 **Business Investment in Plant and Equipment, 1980–84**
(in billions of constant 1972 dollars)

	Amount	% change from previous year
1980	159.1	+ 0.6
1981	158.9	− 0.1
1982	150.3	− 5.4
1983	144.9	− 3.6
1984	164.7	+13.7
Annual rate of change 1980–1984		+0.9%/year
Compare:		
Annual rate of change 1976–1980		+6.5%/year

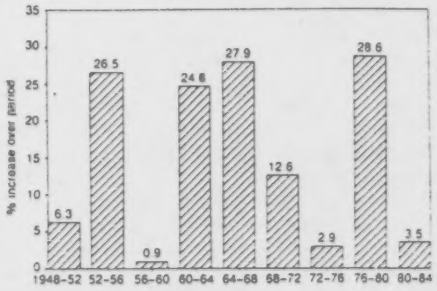
Why tax incentives don't work

The evidence is overwhelming that the billions of dollars spent each year on corporate tax "incentives" are wasted. While the generosity of our tax code certainly has enlarged the after-tax profits of many corporations, it has not produced the investment gains promised by corporate lobbyists. There are, of course, low-tax firms that have added to their investment. And there are high-tax companies that have cut investment. But, overall, it was the fifty most highly taxed firms covered by our study that in the aggregate increased their investment, while the lowest-taxed firms made substantial reductions in capital spending.

One reason for the corporations' behavior is that, in the real world, companies invest only when they need new plant and equipment to produce products they can sell to consumers. When consumers don't spend money, plants are idled and new investment drops.

As the ink was drying on the Reagan tax bill in August 1981, the business managers responsible for investment decisions (as opposed to the corporate lobbyists, whose mission is to lower corporate taxes) began explaining why the massive new tax incentives really wouldn't increase their investment plans after all. The chairman of one major U.S. corporation told *The New York Times* that "with or without the tax bill we would have done what we did in 1981 and what we plan to do in 1982. One can spend money on men and materials only at a given rate. Beyond that it becomes foolish."

Figure 2 **Changes in Real Plant and Equipment Investment (over presidential terms, 1948–84)**



The annual reports of the companies included in our study provide many confirmations that corporate investment decisions are driven by demand-side market forces rather than by supply-side theories. W. R. Grace & Co., for example, despite $684.1 million in

profits between 1981 and 1983, actually made $12.5 million off the tax system by selling its excess tax breaks. At the same time, it reduced new investment by 15.8 percent in 1982 and by another 37 percent in 1983. In its 1983 annual report, the company offered a simple and cogent explanation: the cut in investment was made in "response to the reduced demand" for its products.

Such demand-side economics was endorsed by many other firms as well. Tenneco cited "the weakness in natural-gas demand" to explain its 31.8 percent investment cut between 1981 and 1983, despite its use of tax "incentives" to pay no taxes on $2.7 billion in profits and claim an extra $189 million in tax rebates. Colt Industries, which was extremely active in lobbying for the "investment incentives" in the 1981 Reagan tax bill, saw its capital spending peak in 1980. By 1983, Colt had reduced its investment spending by 39 percent from 1980, explaining to shareholders that "the slow recovery in capital spending by American industry continued to affect our capital goods businesses."

Of course, companies like Colt Industries, Tenneco, and other capital-intensive firms benefit from tax breaks like ACRS whether or not they actually increase the level of their new investment. In effect, ACRS, the investment tax credit, and other loopholes reward companies for doing what they would do anyway.

While these tax breaks may not increase corporate investment, they do increase after-tax profits. The added corporate cash flow they generate *may* be used for additional investment, but it also may be used to increase dividends, expand cash reserves, fund mergers or acquisitions, raise executive pay, or increase advertising budgets.

Our study has documented the increase in dividends while investment was declining between 1981 and 1983: our 238 companies raised dividends by 17 percent over the three years while slashing investment 15.5 percent and paying only 14.3 percent of their profits in taxes. Of the firms studied, 126 (52.9 percent) cut investment—and of these, 109 increased dividends.

Many companies noted in their annual reports that they had added substantially to their cash reserves. For example, General Electric, the champion refund recipient, which cut its investment by 15 percent from 1981 to 1983, reported that by the end of 1983 it had amassed "almost $3 billion in liquid funds" (cash and marketable securities). Phillips Petroleum, whose investment fell 57.2 percent between 1981 and 1983, says that at the end of 1983 it had $906 million in cash on hand. Colt Industries bragged about its "determined effort to improve liquidity . . . . Through these efforts, . . . capital expenditures were held to $36.3 million," while "cash and marketable securities were $164.9 million at December 31, 1983, an increase of $19.6 million [13.5 percent] over 1982." Fluor Corporation, after relating (in a section of its annual report humorously captioned "CAPITAL INVESTMENT CONTINUES STRONG") how its 1983 investment had fallen by 42.6 percent from 1982 and by 32.6 percent since 1981, reported that it increased cash and short-term investments by $64.8 million in 1983, an 80.1 percent jump from 1982. And Union Pacific Corp., which cut its investment by 20.1 percent from 1981 to 1983 and increased dividends by 48.4 percent while paying an effective tax rate of only 3.5 percent, reported that "cash and temporary cash investments" rose to $751 million in 1983, an increase of $296 million (65 percent) over 1982 and an increase of $676 million (901 percent) over 1981.

Many companies have also reported substantial use of funds to acquire other firms—not surprising, given the record-breaking $209-billion wave of mergers from 1981 to 1983 (with 1984 setting another $100-billion-plus record). Phillips Petroleum, for example, notes that it spent $1.2 billion in 1983 to acquire the General American Oil Company of Texas. Fluor spent $1.6 billion in 1981 to acquire St. Joe Minerals. CSX, which cut investment by 38.4 percent between 1981 and 1983 despite its negative tax rate, spent $1.1 billion in 1983 to acquire Texas Gas Resources Corporation. Union Pacific acquired the Missouri Pacific Corporation in December of 1982 for $998 million. And Air Products and Chemicals, which cut its 1983 investment by almost one-third from its 1980 level despite a tax rate of −4.6 percent, used $210 million in cash in 1982 to purchase the Stearn-Roger group of companies.

It's time to stop the waste

In order to protect taxpayers against "waste, fraud, and abuse" when government provides aid to our poorest citizens, Congress has created an extensive set of rules and regulations requiring the poor to disclose

even the most intimate details of their personal lives in exchange for government assistance. But when government assists our richest corporations with billions of dollars in "investment tax incentives," the pious commitment of Congress to protect the rest of the taxpayers from "waste, fraud, and abuse" vanishes.

If the president and Congress held our largest corporations to the same standard of accountability they apply to the poorest welfare recipient, no corporate lobbyist—no matter how persuasive, no matter how many campaign contributions he or she may control—could prevent the repeal of ACRS, the investment tax credit, and the host of other "incentives" which, on the evidence, have failed to achieve their stated objective.

Figure 3 **Changes in Corporate Tax Expenditures and Real Plant and Equipment Investment, 1981-83**

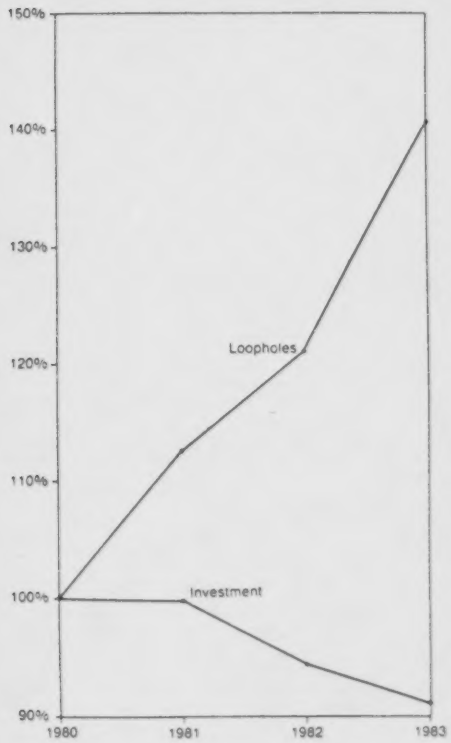


Table 4 **Revenues Saved by Repealing ACRS and the Investment Tax Credit (in billions of dollars)**

	1986	1987	1988	1989	1990	Five-year total
ACRS	6.7	21.9	41.8	61.6	80.9	212.9
Investment credit	15.7	30.4	34.2	37.5	40.9	158.8
Total	22.4	52.3	76.0	99.1	121.8	371.7

Source: U.S. Treasury Department, *Tax Reform for Fairness, Simplicity and Economic Growth*, November, 1984

This double standard is especially intolerable when the federal government is facing annual budget deficits in excess of $200 billion for the foreseeable future. Between 1981 and 1983, the 238 companies in our study used the many "incentives" in our tax code to avoid almost $90 billion in federal taxes, yet they reduced their investment. As Figure 3 shows, looking at the economy as a whole, business investment declined by 9 percent between 1980 and 1983 while the cost of federal corporate tax loopholes rose 41 percent. In view of this dismal record, how can members of Congress consider new limitations on Social Security payments or cuts in health benefits for veterans while billions of dollars are being wasted on corporate tax subsidies intended to encourage investment that has never materialized?

In its tax reform plan released in November 1984, the Treasury proposed repeal of ACRS, the investment tax credit, and most other corporate tax loopholes, together with a reduction in corporate rates. As noted in Table 4, repeal of ACRS and the investment credit alone would raise over $120 billion a year by 1990. Another way to state the issue is that failure to repeal ACRS and the investment credit will mean that by the end of the decade, the federal government will be wasting over $120 billion a year on tax incentives that, on the evidence, don't work.

Corporate tax reform can work. Restoring corporate America to the tax rolls can obviate the need to cut Social Security or veterans' benefits. It can help reduce the deficit. And it can help strengthen our economy by forcing our corporations to stop relying on lobbyists and loopholes to bolster profits and, instead, to go back to making money the old-fashioned way: earning it.

STATEMENT BY NANCY DUFF CAMPBELL, CO-CHAIR, COALITION ON WOMEN AND TAXES, AND MANAGING ATTORNEY, NATIONAL WOMEN'S LAW CENTER, WASHINGTON DC

Ms. CAMPBELL. Thank you, Senator. I'm happy to be here today. I am here with Maxine Forman, and we are appearing not only on behalf of our respective organizations but because we co-chair a Coalition on Women and Taxes, which is comprised of about 50 groups that have been analyzing the reform proposals for their impact on women, and we will be submitting for the record a statement on behalf of the entire Coalition as well.

The CHAIRMAN. I am also going to put in the record the Women and Federal Income Tax System discussion paper that was prepared under Ms. Forman's direction. It is a very, very good paper, and I want it part of this record.

Ms. CAMPBELL. Thank you very much.

[The statement of Nancy Duff Campbell and Maxine Forman follows:]

STATEMENT OF

COALITION ON WOMEN AND TAXES

PRESENTED BY

NANCY DUFF CAMPBELL
Co-Chair, Coalition on Women and Taxes and
Managing Attorney, National Women's Law Center

and

MAXINE FORMAN
Co-Chair, Coalition on Women and Taxes and
Director of Policy Analysis, Women's Equity Action League

On

TAX FAIRNESS FOR WOMEN

Before the

COMMITTEE ON FINANCE
UNITED STATES SENATE
UNITED STATES CONGRESS

June 19, 1985

We are submitting this statement on behalf of:

American Association of University Women
American Jewish Congress
Americans for Democratic Action
BPW/USA
Center for Law and Social Policy
Center for Women Policy Studies
Child Welfare League of America
Children's Defense Fund
Children's Foundation
Church of the Brethren, Washington Office
Divorce Taxation Education, Inc.
Family Service America
Federally Employed Women
Mexican American Legal Defense and Education Fund
Mexican American Women's National Association
National Black Child Development Institute
National Commission on Working Women
National Organization for Women
National Women's Law Center
National Women's Political Caucus
O'Connell & Kitrell
Older Women's League
Organization of Pan Asian American Women
Parent Without Partners
Unitarian Universalist Association of Congregations, Washington Office
United Church of Christ, Office for Church in Society
Washington Lawyers' Committee for Civil Rights Under Law
Women's Equity Action League
Women's Legal Defense Fund
Women's Technical Assistance Project
YWCA of the USA, National Board

These groups, as well as several others that have submitted individual statements to the Committee on tax reform, comprise the Coalition on Women and Taxes. This coalition, which includes a diverse group of women's, children's, religious, aging, civil rights and civic groups, has been meeting since early in the year to analyze national tax policy as it affects women and to assess the various reform proposals and their impact on women.

We have made tax issues a priority for our organizations because tax policies must meet women's basic economic needs. The past several decades have seen a dramatic change in the nature of the responsibilities that women have assumed. Although over 40% of women are not in the paid labor force and maintain the important role of homemaker, women have entered the labor market in unprecedented numbers. In 1960, only 38% of women worked outside the home in paid employment, while by 1982 that figure reached 53% and climbed to 63% for women between the ages of 18 and 64. Moreover, an increasing number of women are combining paid employment and family responsibilities: in the past three decades, the labor force participation rate of mothers has more than tripled. Today, nearly 60% of the mothers of school-aged and infant children are in the labor force, almost double the number in 1960.

The changing nature of women's work and family responsibilities has in part been the result of the increasing numbers of women who are the sole or principal source of economic support for their families. In 1983, female-headed families constituted over 15% of all families, compared to 10% of all families in 1970. For Black families the percentage is even greater; in 1983, 41.9% of Black families were headed by women, an increase from 28% in 1970. In Hispanic families, the percentage of female-maintained families increased from 15% in 1970 to 23% in 1983; among Puerto Rican families, 41% were maintained by

women. About one-quarter of Native American families were maintained by women.

Finally, despite the growth in the numbers of women in the paid labor force, the spectre of poverty has become a reality for greater numbers of women than ever before. Today, women and children constitute 75% of the poor in this country, and nearly 50% of all poor families are headed by women, up from 25% of all poor families twenty-five years ago. The percentage of minority families maintained by women who are poor is even higher: approximately 57% of all Black and Hispanic families are female-maintained.

Our objective here today and throughout the debate in coming months is to ensure that national tax policy as it is reshaped by Congress and the Administration is responsive to the basic economic facts of life for women. We welcome the prospect of tax reform. We are encouraged that women, particularly low-income women, stand to improve their status if some of the provisions in the reform proposals are enacted. We will, however, suggest additional improvements in order to ensure maximum fairness and equity to the full range of women who are affected by national tax policy.

The cornerstone of our support for tax reform derives from our agreement with the underlying principle of the major reform proposals: that tax rates can be brought down by eliminating many preferences and deductions which have enabled high-income individuals and corporations to escape taxation. As upper-income

individuals and corporations have sheltered more and more of their income, and enjoyed little or no tax liability, others have been paying at higher and higher marginal rates -- shouldering the tax burdens thrust upon them because others have avoided their fair share. Whether as workers in paid employment or homemakers, whether in one- or two-earner couples, whether as single heads of households, or elderly women living alone, women have been bearing the brunt of a tax system which takes their last dollars but permits the wealthy and corporate America to pay little or no tax. In short, the potential gain for women under tax reform is great.

However, tax reform must provide not only lower rates and a broadened base, but also must provide fairness to individual taxpayers, particularly those at the low and middle end of the income scale. Each of the major reform proposals is built around the premise of lower rates in exchange for fewer preferences and deductions, but each offers a somewhat different approach. The Administration proposes creating three different individual tax rates of 15%, 25% and 35%; Bradley-Gephardt proposes three rates of 14%, 26% and 30%; Kemp-Kasten generally imposes a flat tax of 24% on all income. From the initial analysis which we have done, we are concerned that none of the major plans is progressive enough and requires of upper-income taxpayers an obligation commensurate with their ample ability to pay. In addition, there are adequacy and equity issues of special concern to women, both in their capacity as workers in paid employment and as spouses and parents, which we address in more detail below.

TAX THRESHOLD: ADEQUACY FOR LOW INCOME WOMEN AND FAMILIES

As we have stated above, eliminating the tax burden on the poor is a priority issue for us. We are, of course, heartened to see that this principle has guided all the major reform efforts to date and we are particularly pleased that the Administration's new proposal provides relief for individuals and families at or near the poverty level. Indeed, exempting those at or near poverty from federal income taxation is so essential that it must remain an absolute sine qua non of any reform plan which Congress ultimately adopts.[1]

Current Law

Under the current law, the tax burden on the poor -- three-quarters of whom are women and their dependent children -- is harsh and getting harsher each year. The facts speak for themselves: Since 1978, the tax burden on the poor has risen dramatically as families of four at the poverty line have seen their combined federal income and payroll taxes increase from $269 to $1,147, and from 4% to over 10.4% of their income. Between 1980 and 1982, the number of persons in poverty paying federal income tax more than doubled. While the point at which a family began paying federal income tax was 21.7% above the poverty line in 1975 -- thus exempting poor and near-poor families from income tax -- a decade later, in 1985, this tax threshold was nearly 20% below the poverty line, thus forcing many families with poverty and below-poverty level earnings to pay income tax. In short, the 1981 tax cuts enjoyed by so many

Americans simply ignored those at the lower end of the income scale. Women and their children, the vast majority of the poverty population, sank deeper into poverty, in part as a result of tax policies which have failed to keep up with their needs.

The three provisions which together determine the tax threshold are the personal exemption, the zero bracket amount (formerly called the standard deduction), and the Earned Income Tax Credit (EITC). Since 1979 the personal exemption has been $1,000, but with the start of indexing in 1985 it will increase to $1,040 and to $1,080 in 1986. The zero bracket amount varies according to a taxpayer's filing status. Single persons and single heads of households for many years have had a zero bracket amount of $2,300. With indexing it will rise to $2,390 in 1985 and to $2,480 in 1986. For married couples, the zero bracket amount has been $3,400 since 1979. With indexing, in 1985 it will rise to $3,540 and to $3,670 in 1986. The third provision affecting whether low-income families pay federal income tax is the EITC. The EITC is a refundable credit -- available to families with children and earned incomes of less than $11,000 -- of approximately 11% percent of the first $5,000 of earned income, for a maximum of $550. It was enacted in 1975 to encourage workforce participation by offsetting the effect of rising payroll taxes on low-income workers and, as such, has been of special benefit to low-income women heads of households. Payroll taxes have risen considerably since 1975, however, but the EITC has not been adjusted either to the rise in payroll taxes or to account for inflation. Although Congress last year

increased the eligibility ceiling for this credit to $11,000, in 1985 and subsequent years the poverty line for a family of four and all larger size families will exceed $11,000, rendering the EITC unavailable to some working families who live in poverty.

The personal exemption, the zero bracket amount, and the EITC, structured originally to work together to protect poverty-level individuals and families from paying federal taxes, have failed in recent years to accomplish this goal and more and more low-income families are being required to pay federal income tax on an increasing portion of their meager earnings. Even with the beginning of indexing in 1985, because so many poor families have already been required to pay income tax and because the EITC is not indexed, this change will not provide tax relief for poor families.

Reform Proposals

The changes proposed by the Administration in the three provisions directly affecting the poor substantially eliminate the unfairness in current law for heads of households and married couples but not for singles. The new Treasury plan proposes increasing the personal exemption to $2,000, effective in 1986. The plan increases the zero bracket amount for singles to $2,900 (from $2,480), for married couples to $4,000 (from $3,680) and for single heads of households to $3,600 (from $2,480). The EITC will be increased to 14% of the first $6,500 of earned income and would phase out at $13,500, thus providing a maximum credit of $700. To avert erosion through inflation, each provision would be indexed and poverty-level families should be assured over time of relief from federal income tax.

Both the Bradley-Gephardt and Kemp-Kasten proposals also make significant improvements over current law on tax threshold issues, though Bradley-Gephardt particularly has shortcomings, which, when viewed against the Administration's proposal, make the latter proposal preferable. Bradley-Gephardt has a three-tiered personal exemption: $1,600 for taxpayers and their spouses, $1,800 for heads of households and $1,000 for dependents. Zero bracket amounts are raised to $6,000 for married couples, and to $3,000 for single taxpayers and single heads of households. Bradley-Gephardt brings some married couples above the poverty threshold. However, because the zero bracket amount for heads of households remains the same as for single taxpayers, and because the exemption for dependents is lower than for adults, this bill makes the tax threshold much lower for single heads of household than for married couple families of the same size. For example, a married couple with one child would have $10,200 of tax-free income ($6,000 in zero bracket amount and $4,200 in exemptions), while a head of household with two dependents would have only $6,800 tax-free income ($3,000 in zero bracket amount and $3,800 in exemptions). Moreover, the EITC is not changed, and none of the provisions is indexed. The failure to index the provisions which determine the tax threshold makes any gains for low-income families short-lived, since inflation will erode any relief achieved.

Despite the fact that the straight flat tax of 24% in the Kemp-Kasten bill is on the surface unfavorable for low-income

families, it is structured in such a way that poor families are exempt from federal income tax. Like the Administration bill, the personal exemption is $2,000 and indexed. Zero bracket amounts are raised to $2,600 for singles, to $3,300 for married couples, and to nearly that level, $3,200, for single heads of households, and are indexed. The bill also expands the Earned Income Tax Credit to 14.3%, ties the percent to the combined employer/employee Social Security tax rate, and adds a dependent allowance so that larger families receive more of a benefit than smaller families. However, the credit is phased out at lower earnings levels than under the Administration bill, or under current law. Thus, it appears that some working families currently eligible for the credit would lose it.

In assessing the approaches to eliminating the tax burden on the poor, it is our view that Congress should be guided by several principles. First, and most importantly, there must be a sacrosanct commitment to ensure that families at or near poverty are exempt and continue to be exempt from federal income tax. Secondly, the provisions adopted must provide relief to all poor and near-poor individuals and families -- singles, single heads of households, and married couples with one earner and with two earners. Finally, in putting together a combination of provisions -- the personal exemption, the ZBA, and the EITC -- preference must be given to expanding those features which give the most relief to low-income families -- ZBAs and the EITC. Raising the personal exemption helps to provide important relief, especially to larger families, but because it benefits wealthiest

taxpayers most, it is a less efficient and more costly way of helping low-income families.

We offer our support for changes which remove poverty and near-poverty level families of all types from the federal income tax rolls and pledge the resources of our Coalition on Women and Taxes to ensure that this goal is incorporated in all versions of tax reform which are considered and adopted by Congress. Any proposal which does not result in exempting poor families and individuals from federal income tax will be viewed as a retreat by Congress and the Administration from their commitment to tax reform and will force us to reconsider our commitment to tax reform efforts we have pledged to support.

Further Improvements

The tax threshold provisions which have been advanced in the reform proposals discussed above could be improved in several important respects to offer even more protection to low-income individuals and families. As discussed in another part of our statement, no proposal eliminates entirely the disparity between the tax burdens of single heads of households and married couples. We urge the Committee to raise the ZBA for heads of households to the level enjoyed by married couples, as provided in the Economic Equity Act, S. 1169, and to equalize their tax rates as well.

Another improvement which the Committee should consider is expansion of the group of low-income earners eligible to receive maximum benefit from the EITC. Although the Administration proposal raising the EITC from 11% to 14% and permitting it to

phase out at $13,500 instead of $11,000 is an important improvement over current law, we prefer the proposal contained in the Economic Equity Act. That proposal raises the earnings level eligible for the maximum credit to $16,000, increases the percent to 16%, and begins the phase-down of the credit at $11,000. We urge the Committee to commit itself to go beyond the proposals for very low-income working families which the Administration has advanced and expand the EITC along the lines we have suggested.

TAX THRESHOLD: ELDERLY AND DISABLED WOMEN

The tax threshold is particularly important to elderly and disabled people because of attendant expenses of age and disability. To provide equity to these individuals, their tax threshold should be higher than the tax threshold of other individuals. Clearly, the tax code must maintain provisions which tax elderly and disabled people fairly and allow them to maintain an adequate standard of living.

Fairness to low-income elderly and disabled individuals is an especially important principle for women. Women are 60% of people over the age of 65, and 70% of those over 85 years of age. Over three-fourths of elderly women have incomes under $10,000 a year. The median annual income of all elderly women from all sources (earnings, interest, pensions and Social Security) was only $5,599, as compared to $9,766 for men in 1983. Only 8% of elderly women are in the workforce, with median annual earnings of $3,150. One in three single elderly women and one in two single elderly Black women receiving Social Security depend on it for more than 90% of their income. The poverty rate

for elderly women is nearly 18%. Forty-nine percent of elderly white single women and 80% of elderly Black single women live at or near the poverty level.

Disabled women are disproportionately represented in poverty, too. Women are 74% of all the disabled poor. In general, Black and Hispanic origin individuals are 25% more likely to be disabled than white individuals. Over 90% of severely disabled women are completely out of the workforce as compared to 80% of the men.

Elderly and disabled women often have health conditions which require them to make more frequent visits to the doctor and have longer than average hospital stays. As a result, according to one study, the elderly incur out of pocket health care expenses averaging over $1,500 a year.

Current Law

The higher tax threshold for the elderly under current law recognizes that elderly persons, millions of whom are single women living on small fixed incomes, often incur high medical expenses or related costs which reduce their ability to pay taxes.

Under current law, persons with low and moderate incomes do not pay income tax on Social Security benefits, including disability benefits. Tax is imposed on the lesser of: (1) one-half of the taxpayer's Social Security benefit; or (2) one-half of the amount by which the taxpayer's combined income (AGI plus one-half of the Social Security benefit) exceeds $25,000 for single returns and $32,000 for joint returns. The income

thresholds are not indexed. Very few elderly and disabled women currently have incomes above the thresholds, but the number will increase with inflation.

In addition to exempting Social Security benefits from taxation for low and moderate income people, current law provides an extra personal exemption for the blind and the elderly as well as a nonrefundable, unindexed credit for certain individuals age 65 and over and certain disabled individuals.

The Administration's Proposal

The Administration's proposal maintains and improves the tax threshold for the elderly and the disabled. Through an expanded and indexed credit, coupled with the doubling of the personal exemption, the plan substantially raises the tax-free levels of income for the elderly and disabled individuals.

Tax-free levels of income for people age 65 or older and blind individuals with average Social Security benefits are raised from $10,640 to $11,900. For disabled individuals under age 65 the tax-free level is raised from $9,383 to $10,400. The extra personal exemptions for the elderly and blind, which are worth more to higher income taxpayers, are repealed. Also, the Administration's plan maintains the current law treatment of Social Security benefits.

Because of the special significance of the tax threshold to elderly and disabled women, we support the provisions in the Administration's proposal which maintain and improve the level of the tax-free income. We especially support repealing the extra personal exemption which benefits higher income individuals who

require the least help and replacing it with an expanded and indexed credit which targets help to lower and moderate income people.

TAX EQUITY FOR SINGLE HEADS OF HOUSEHOLDS

Equity between similarly situated families is a principle that must be adhered to in any tax reform proposal. This principle requires that single heads of households and married couples with the same income and family size be treated similarly by our tax code. Current tax provisions which cause heads of households to pay more taxes than married couples with the same income and family size must be changed so these families are treated equally.

The IRS defines heads of households as single taxpayers maintaining a home for over half the year for a child, grandchild or any dependent, or separated taxpayers maintaining a home for a dependent child. A large and increasing number of taxpayers file as heads of households. In 1982, over 8.4 million taxpayers filed as heads of households. This represented almost 9% of all returns filed. While the total number of returns filed decreased between 1981 and 1982, the number of head of household returns increased by more than 8%.

Most heads of households are single parents maintaining homes for dependent children. Over 85% of heads of households claimed dependent children in 1982. Although the IRS maintains no data on the number of women who file as heads of households, statistics show that nearly 90% of single persons maintaining families with children under 18 years of age are women. In a

little more than a decade, the proportion of families with children under age 18 maintained by single women has nearly doubled, rising from 10% in 1970 to 19% in 1983.

The Inequitable Tax Burden on Single Heads of Households

In addition to problems of single parenthood, pay inequity, and high unemployment, single women maintaining families are shouldered with an inequitable tax burden. Single women and their families can ill afford this burden. Over 22% of families maintained by single women with employment income lived below the poverty level in 1983. The median annual income for single women maintaining families was only $11,789.

The household expenses for a head of household are roughly comparable to those of a married couple with the same income and family size. A survey by the Bureau of Labor Statistics indicates that while household budgets vary slightly depending upon the ages of the householders and the children, the cost of a budget for a family maintained by a single parent is very close to and in some instances greater than the cost of a budget for a same-size family maintained by a married couple. Indeed, the poverty level is set higher for a head of household with one dependent than for a married couple with no dependents. Married couples with dependents have the same poverty level as heads of households with same-size families.

Current Law

Although their household expenses are comparable, heads of households and married couples with the same income and same-size

families do not pay the same amount of federal income tax. Heads of households pay more. In 1984, a head of household with $10,000 of income, no special credits or deductions, and two dependents paid 35% more tax than a married couple with the same income and one dependent. The same head of household with $20,000 of income paid 19% more tax than a comparable married couple.

The differential between the tax liability of heads of households and married couples is caused by two provisions: the zero bracket amounts (ZBAs) and the tax rate schedules. Heads of households have the same ZBA as single taxpayers without dependents. They currently have a ZBA of $2,300 compared to $3,400 for married couples filing joint returns. Because the ZBA tends to be most significant for lower-income taxpayers, the tax penalty on heads of households compared to married couples generally is greatest for lower to middle income taxpayers. In addition, the tax rates for heads of households are higher than those for married couples filing jointly. Heads of households have an intermediate tax rate schedule with rates between the rates for married couples and single taxpayers.

Equity Between Heads of Households and Married Couples

Equity dictates that heads of households not pay more income tax than married couples with the same income and family size. Heads of household should bear the same tax burden as similarly situated married couples. This requires use of the same ZBA and tax rates for both filing statuses. The 1985 Economic Equity Act raises the ZBA for heads of households to the amount currently

available for married couples. Using ZBA levels in current law, the cost of raising the ZBA for heads of households was estimated in 1984 to be about one billion dollars a year. This amount would be a small price to pay to achieve greater fairness and to ease the tax burden on heads of households who are working to support themselves and their families.

Current Proposals

Two of the three major tax reform proposals address the inequity between single heads of households and married couples which exists under current law. The Administration's proposal and Kemp-Kasten partially remedy the current disparity although neither achieves complete equity. The Administration proposal raises the ZBA for heads of households to $3,600 compared to $4,000 for married couples but retains an intermediate tax rate schedule for heads of households. Kemp-Kasten raises the ZBA for heads of households to $3,200 compared to $3,300 for married couples and imposes a single tax rate on all taxpayers. Thus, Kemp-Kasten very nearly eliminates the penalty on heads of households, while the Administration's proposal reduces the penalty to some degree. We support the intent of these measures although neither achieves our goal of complete equity for heads of households.

The Bradley-Gephardt proposal exacerbates the inequity in current law and increases the penalty on heads of households. As explained earlier*/, the proposal increases the differential

*/ See p. 8.

between the ZBAs for heads of households and married couples, retains an intermediate tax rate schedule for heads of households, and gives a lower total exemption to heads of households than to married couples with same-size families. These provisions create inequity not only in the tax threshold of heads of households, but also in their tax liability. For example, a head of household with an income of $10,000 and two dependents pays 448% more federal income tax under Bradley-Gephardt than a married couple with the same income and one dependent. At $15,000 of income, the head of household pays over 70% more tax and at $40,000 of income she pays over 54% more tax.

The goal of equity for single heads of households requires that Congress recognize the greater tax burden on single women maintaining families compared to married couple families of the same income and family size. To correct this glaring inequity Congress should equalize the ZBAs and tax rates for heads of households and married couples.

TAX EQUITY FOR TWO-EARNER COUPLES

The tax code must continue to give a tax deduction to married couples where both partners are employed. This provision recognizes the greater nondeductible employment-related expenses incurred by two-earner couples than by one-earner couples and the effect of these expenses on ability to pay. It also eases the so-called marriage penalty, under which two-earner couples pay more federal income tax than two single taxpayers with comparable incomes.

More than half of all wives are in the labor force. Most join the labor force out of economic necessity. On average, wives contribute about 30% to total family income when both partners are employed and 16% of working wives contribute more than half. A second income keeps many families from falling below the poverty level. The two-earner deduction helps two-earner couples to realize a fair return on their work efforts.

The Greater Expenses of Two-Earner Couples

Two-earner couples incur greater nondeductible employment-related expenses than one-earner couples. The major increases are for transportation, clothing, and in many instances Social Security taxes. According to a study based on Consumer Expenditure Survey data, a two-earner couple spends over 17% more than a one-earner couple on employment-related expenses.

The Marriage Penalty

Most two-earner couples currently pay more federal income tax than two single taxpayers with comparable incomes. This marriage penalty is caused by two factors. First, the zero bracket amount for married couples is less than the combined zero bracket amount for two single taxpayers. In 1984, the zero bracket amount for married couples was $3,400 compared to $2,300 for each single taxpayer or $4,600 for two single taxpayers. This portion of the penalty especially affects low-income taxpayers to whom the zero bracket amount is most significant. Second, the progressive tax rate structure places a higher effective tax rate on a couple's second $10,000 of income than on a single taxpayer's first $10,000 of income.

Current Law

Current law allows two-earner couples to deduct 10% of the salary, up to $30,000, of the lesser earning spouse, yielding a maximum deduction of $3,000. The two-earner deduction is allowed only for income attributable to employment; it is not available, for example, for pension or annuity income. The deduction is taken from gross income and thus is available to nonitemizers.

The two-earner deduction recognizes the increased employment-related expenses incurred by two-earner couples. It also helps to offset the marriage penalty. Without the deduction, a two-earner couple where each spouse earned $10,000 would have paid 15% more in federal income taxes in 1984 than two single taxpayers with the same incomes. With the deduction, however, the penalty was reduced to 5%.

Preliminary data from 1983 indicate that the deduction is used primarily by low- and middle-income couples. Almost 22.7 million couples claimed deductions in 1983. Over one million of those couples had combined incomes under $10,000 a year. Over 30% of couples claiming the deduction had incomes under $25,000 and nearly 70% had incomes under $40,000 a year.

Current Proposals

All the major tax reform proposes would repeal the two-earner deduction. Hence, none of the proposals recognizes the increased expenses of two-earner couples, and only one of them significantly reduces the marriage penalty on two-earner couples.

Without the two-earner deduction, all married couples will be taxed alike even though two-earner couples have greater expenses. Failure to recognize the increased expenses of two-earner couples appears to reward married women for staying out of the workforce.

The Administration claims that the lower, flatter tax rates contained in its tax proposal will remedy the marriage penalty and make the two-earner deduction unnecessary. Flattened tax rates will help to some degree, because many couples now pushed into a higher marginal tax bracket because of the second earner will remain in the same tax bracket. However, the flattened rates do not resolve the issue fully. Because of the relationship of the ZBAs for singles and married couples, a substantial marriage penalty on many couples, especially at low and moderate income levels, will continue under this plan. For example, a two-earner couple with no dependents, where each spouse earns $5,000, will pay 900% more federal income tax than two single taxpayers with the same incomes, and a couple where each spouse earns $10,000 will pay 18% more tax than two singles. Kemp-Kasten also imposes a substantial marriage penalty on many low and moderate income couples. Under this plan, the couples will pay 168% more tax than the single taxpayer. A couple where each spouse earns $10,000 a year will pay 28% more than two single taxpayers under Kemp-Kasten. Low and moderate income couples can least afford an increased penalty. These are the same couples that lose the most if the Dependent Care Tax

Credit is converted to a deduction as several of the tax reform plans propose.*/

The Bradley-Gephardt proposal gives married couples a zero bracket amount exactly twice the zero bracket amount for single taxpayers. This proposal eliminates the marriage penalty for two-earner couples with incomes under $40,000 a year. However, the increased zero bracket amount is very costly and gives many married couples increased marriage bonuses.

The two-earner deduction was enacted in 1981 after careful and extensive consideration. Several proposals were studied, analyzed and discussed and voluminous testimony was heard. Congress concluded that the deduction, while not a perfect answer, was the best available solution for an existent and complex problem. The problem has not disappeared and does not disappear under any of the tax reform proposals. The federal tax system should continue to strive to avoid penalizing taxpayers for either their marital or employment status and to take into consideration extra expenses which affect ability to pay taxes. Tax reform should improve, not eliminate, the current provision for two-earner couples.

EQUITY FOR ONE EARNER COUPLE: SPOUSAL IRAs

One earner and two earner couples should be permitted to benefit equally from the establishment of Individual Retirement Accounts (IRAs). This could be accomplished by allowing each spouse to contribute up to $2,000 ($4,000 for a couple) to an IRA, even if one spouse has little or no earnings.

---

*/ This proposal is discussed on pages 24-30.

Current Law

Under current law wage earners may establish a tax-sheltered IRA and contribute up to $2,000 per year (or the amount of their earnings, whichever is less) to such accounts. In cases where the wage earner is married to a spouse with no earnings, the couple may contribute up to $2,250 (or the amount of the wage earner's earnings, whichever is less). The contribution may be divided between the spouses in any way they choose for retirement purposes, provided that neither account is credited with more than $2,000. (If the wage earner contributes the maximum $2,000 to his or her account, the non-earning spouse is limited to a contribution of $250 towards retirement). Thus families with two earners may shelter as much as $4,000 each year and draw retirement benefits based on such contributions, while couples with one earner may shelter only $2,250 each year and draw retirement benefits based on these smaller contributions.

Reform Proposals

The Administration's proposal corrects the inequity for homemakers in current law. The provision is identical to the IRA proposal in the 1981 and 1983 Economic Equity Act. It would increase from $2,250 to $4,000 the limit on IRA contributions for one-earner families who have $4,000 of earned income, even if one spouse has little or no earnings. Thus, all married couples would be permitted to shelter up to $4,000 per year in an IRA, provided that no more than $2,000 were contributed to each

account. (The 1985 EEA provides for a 3-year phase-in of this proposal).

We support the Administration's proposal because it recognizes the homemaker's contribution to marriage as equal to that of the wage earner's and would increase retirement income for homemakers married to wage earners with incomes high enough to take advantage of the higher contribution limit. In addition, the proposal provides equity between one-earner and two-earner couples by allowing all married couples to contribute up to $4,000 per year to IRA accounts.

However, while we support the Administration's proposal to provide equity to one-earner couples through expanded IRAs, we object to the Administration's proposals which lessen equity for other families, including those with two earners: the elimination of the two-earner deduction and the conversion of the dependent care tax credit to a deduction with less value for low to moderate income families.

The Kemp-Kasten and Bradley-Gephardt proposals make no changes in current law treatment of spousal IRAs.

DEPENDENT CARE EXPENSES: TAX EQUITY FOR WOMEN AND FAMILIES

Another issue that must be considered to assure equity in any tax reform proposal is the treatment of dependent care expenses, since families and individuals with these expenses have less ability to pay taxes than taxpayers without such expenses. This difference in ability to pay must continue to be recognized by the tax code and, indeed, the current tax credit for dependent care expenses should not only be retained but expanded to provide

greater recognition of the needs of families and individuals with dependent care expenses.

The recognition of dependent care expenses in the tax code is particularly important to women because arranging care for children and elderly or disabled dependents is a task that falls to women, who are usually expected to provide that care even though their circumstances may not permit them to do so. Over 62% of mothers of school-age children are in the paid labor force. Almost 52% of mothers with children under age six work outside the home, as do 47% of women with a child under the age of one year. These numbers are expected to rise during this decade.

Dependent care responsibilities are not limited to those women in the paid work force who have young children. Many middle-generation women are responsible for older relatives, and some are forced to leave the workforce to provide care for these relatives. According to a 1982 study, 28% of the women out of the paid labor force who were surveyed had quit their jobs because they were needed at home to care for their mothers; 26% of their employed peers had considered leaving their jobs or had reduced the number of hours they worked for the same reason. Disabled relatives also require care. There are approximately

500,000 handicapped children under the age of six and 4.2 million handicapped school-aged children in this country, as well as 8.4 million severely disabled adults between the ages of 18 and 64 who are living in families with at least one other adult. Meeting the need for dependent care for these individuals is a significant responsibility for women.

Current Law

The dependent care tax credit is one way of helping to meet dependent care needs. Under current law, a taxpayer is allowed a tax credit for employment-related expenses incurred for the care of a dependent child or other dependent or spouse who is incapable of self-care. Since the 1982 tax year, the credit has been targeted to provide the greatest benefit to low-income taxpayers. The maximum credit is 30% of expenses up to $2,400 for one dependent (or $4,800 for two or more dependents) for taxpayers with adjusted gross incomes (AGIs) of $10,000 or less. The percentage of the credit declines (by 1% per $2,000 of AGI) to 20% for taxpayers with AGIs of over $28,000.

The dependent care tax credit is the largest source of federal financial support for dependent care. In 1983, according to preliminary IRS data, 6.4 million tax returns claimed the credit, an increase of over one million returns since 1982, for tax expenditures of $2.1 billion. In 1982, the first year the credit was targeted to low-income taxpayers, the number of returns claiming the credit was up 9% over 1981; expenditures were up 39%. Moreover, taxpayers with less than $30,000 in AGI received 61% of the additional monies.

The value of the credit to individual taxpayers is not insignificant either. On average, taxpayers in 1983 reduced their taxes by $322 through use of the credit. Taxpayers with AGIs between $10,000 and $20,000 reduced their taxes, on average, by $354. This value is expected to increase; the projected cost of the credit for the 1984 tax year is $2.5 billion.

Problems in the credit's effectiveness remain, however. First, taxpayers at the lowest income levels cannot take full advantage of the credit because they cannot afford to spend the amounts necessary to obtain the maximum credit ($2,400 or $4,800 depending on the number of dependents), and the credit is not refundable. In 1983, taxpayers with between $5,000 and $10,000 in AGI received, on average, a reduction of $274 in their tax liability because of the credit as compared with a potential maximum reduction for taxpayers at that income level of between $720 and $1,440. Taxpayers with adjusted gross incomes of $5,000 and under reduced their taxes because of the credit by only $27, as compared with a potential maximum reduction of $720 to $1,440.

In addition, because of inflation, the number of taxpayers in the lowest income brackets is decreasing, rendering the credit's current targeting to low-income taxpayers less significant over time. In 1983, for example, the number of taxpayers with AGIs under $10,000 decreased by 462,186.

Finally, unlike the treatment of other costs of doing business, both the percentage limits and the dollar limits of the credit prevent recoupment of the full cost of care. Indeed, given the high cost of dependent care, very little assistance in

meeting that cost is afforded by the credit. The current cost of out-of-home care per dependent ranges from $2,860 to $6,500/year for infant care, $2,340 to $3,900/year for pre-school care, and $5,460 to $6,500/year for adult day care.

To ameliorate these problems, the credit should be expanded to give greater recognition to the fact that taxpayers with dependent care expenses, especially low-income taxpayers, have significantly less ability to pay taxes than those at the same income level who do not have such expenses. The sliding scale should be increased and the credit should be made refundable and indexed. These changes are included in the Economic Equity Act. This Act also laudably expands the credit to cover homemakers caring for disabled adults and children, to provide them with help in obtaining respite care. These changes would help all taxpayers -- especially taxpayers at the lowest income levels -- better meet their dependent care needs.

The Proposals

None of the major tax simplification proposals makes the requisite changes. Indeed, all would reduce the recognition of dependent care expenses contained in current law for taxpayers at low- and moderate-income levels. Taxpayers at $0-$10,000 AGI now receive a 30% credit, declining to 25% at $20,000 AGI and 20% at $28,000 AGI and above. The Administration would give married taxpayers with taxable incomes (substantially lower than adjusted gross incomes) between $4,000 and $29,000 a 15% deduction, those at $29,000-$70,000 a 25% deduction, and those at $70,000 and

above a 35% deduction. This change decreases the value of the credit to taxpayers below $29,000 and increases its value to those above $29,000, especially those above $70,000. Bradley-Gephardt changes the credit to a deduction, and reduces its value to taxpayers at all income levels to 14%, and Kemp-Kasten eliminates the credit entirely, both of which disproportionately affect low- and moderate-income taxpayers who currently receive a 30-20% credit.

We object to these plans, because they eliminate the targeting of the current credit to low-and moderate-income taxpayers, and in the case of the Administration plan, because it does so at the expense of favoring high-income taxpayers. For example, under current law a single head of household taxpayer with AGI of $18,000, and dependent care expenses for one dependent of $2,000 would reduce her tax liability through use of the credit by $520 (26% of $2,000). Her deduction under the Administration's plan reduces her taxes only $300 (15% of $2,000), and under Bradley-Gephardt only $280 (14% of $2,000). In contrast, a single head of household taxpayer at $70,000 in AGI with dependent care expenses of $2,000 would reduce her taxes by $400 under current law (20% of $2,000), as compared with $700 (35% of $2,000) under the Administration proposal and $280 (14% of $2,000) under Bradley-Gephardt. The result is a significant reduction in the tax recognition of dependent care expenses for all families under Bradley-Gephardt and for low- and moderate-income families under the Administration's proposal, with a concomitant increase in the recognition of dependent care

expenses for high-income families. Indeed, the Administration estimates that under its plan the same number of taxpayers will claim the deduction as claimed the credit in 1983; yet the cost will increase by $300 million beginning in 1987. This increase will go to families at higher income levels.

All three plans justify their change from a credit to a deduction, or total elimination of the credit, by claims that their lowered tax rates, increased zero bracket amounts and increased personal exemptions will compensate for the loss. These changes alone, however, fail to reflect that taxpayers with dependent care expenses have less ability to pay taxes than other taxpayers who are also benefiting from lower rates and increased ZBAs and personal exemptions. The Administration and Bradley-Gephardt proposals reflect this in part by retaining some tax recognition for dependent care expenses, but lower their value to low- and moderate-income taxpayers. Kemp-Kasten eliminates recognition of dependent care expenses entirely.

In sum, we believe that at a minimum the current credit with its targeting to low-income taxpayers should be retained. Indeed, it should be expanded as provided in the Economic Equity Act. In no instance should it be eliminated, reduced, or changed to target more of its benefits on high-income taxpayers, as in the three proposals discussed here.

TAXATION OF FRINGE BENEFITS

The tax treatment of certain kinds of employer-provided fringe benefits also raises equity concerns. Health and dependent care are the two benefits which are most basic to

women's economic survival, and because they are such life-line benefits, we are troubled by any proposal to dramatically alter their tax-exempt status. Therefore, we are pleased to see that the Administration has rejected the Treasury proposal made in November to tax employer-provided dependent care. We hope that supporters of tax reform will concur with the Administration's position on this issue and support continuation of current law which exempts from taxation dependent care assistance provided by employers, which is so important to working women and their families.

The Administration's proposal to tax a portion of employer-provided health insurance, modified from the November proposal to tax all employer-provided premiums above a cap of $70 for individuals and $175 per month for family coverage, continues to concern us, however. The Administration now advocates a partial tax on employer-provided health insurance. The first $10 of an individual monthly premium and the first $25 of a premium for family coverage would be subject to tax, at the taxpayer's regular tax rate. Thus, someone with an individual policy would pay taxes on an additional $120 of income annually, which would amount to $18 of additional taxes in the 15% bracket, $30 of additional taxes in the 25% bracket, and $42 of additional taxes in the 35% bracket. Similarly, for family coverage there would be $300 of additional taxable income which would cost the taxpayer $45 in the 15% bracket, $75 in the 25% bracket, and $105 in the 35% bracket. Moreover, this tax increase is actually understated because the additional taxable income will be

included in the Social Security wage base, and as such will increase the amount of Social Security tax as well.

The problem with this approach is not only the tax burden which it imposes, but also that the burden does not bear an accurate relationship to the value of the premium or the family's ability to pay. The $10 and $25 amounts are flat figures which are charged to employees at all income levels, regardless of their different income or earnings. This regressive feature is partially offset by the fact that the tax treatment of the fixed amount is progressive, so that workers with high incomes will pay a higher percentage of taxes than lower-income workers. The $10 and $25 flat amounts, however, constitute a greater portion of taxable income of lower-income workers than of higher-income workers. This regressive effect is compounded by the fact that taxable income is also being added to the FICA wage base, and the FICA tax (7.15 % in 1986, paid equally by the employer and employee) is itself regressive. The result will be that the Administration's approach to taxing health premiums will be more onerous for lower-income workers than for higher-income workers, who will feel less of a bite from the additional taxes they will be required to pay.

The treatment of fringe benefits in other proposals is even more problematic. In the Bradley-Gephardt bill, fringe benefits, including health insurance and dependent care assistance in total, are treated as taxable income. This sweeping approach reflects no sensitivity to the benefits which serve an important social purpose or are of particular value to low-income

workers. The Kemp-Kasten approach to the tax treatment of fringe benefits on its face is preferable than the other two plans because the current exclusions for health and dependent care would continue. However, because of the bill's relatively high flat tax rate, it is not clear whether low- and moderate-income individuals and their families would be helped or hurt by the exclusions, and whether wealthier families would be getting a disproportionate benefit.

* * * * *

Thank you very much for inviting us here today. We look forward to working with the Committee on developing a reform bill which retains the positive provisions we have identified, and which includes the improvements we have recommended. Women and their families will be looking to your leadership.

Ms. CAMPBELL. We believe that tax issues are a priority for women because of their effects on women's basic needs. Despite the increasing number of women in the workforce, nearly 75 percent of the poor are women and children. We welcome tax reform, because we believe that many women, particularly low-income women, will benefit and improve their status. We need not only lower rates and a broader tax base, but fairness to low- and middle-income taxpayers.

We are generally concerned that none of the plans is progressive enough and demands of upper income tax payers a rate which is commensurate with their ability to pay.

Our statement addresses particular issues of concern to women in more detail. Today I will summarize our views on tax threshold and dependent care expenses, and Ms. Forman will cover equity for heads of households and two-earner couples. Other issues are covered in our statement.

On the tax threshhold issues, as this committee has already heard in earlier testimony this week, provisions that work together to keep the poor from paying taxes have failed in recent years to accomplish this. All of the plans make substantial headway in rectifying this problem; however, there is room for improvement in these proposals, too.

Under the Administration bill, for example, single people in poverty will still pay taxes. Bradley-Gephart falls short on the tax treatment of heads of households. There are other improvements needed in all of the bills, too, before a final bill is enacted.

For example, the Administration rectifies the tax burden on the poor since 1981, instead of going back to the 1979 level when the poor paid taxes on an even smaller percentage of their income, if at all. In addition, the zero bracket amounts for single heads of

households and for married couples we believe should be equalized, not simply brought closer together. Ms. Forman will talk about this in more detail.

In addition, we believe that the earned income tax credit should be higher in any tax reform proposal than it is in the current proposals, and support the provisions on this issue that are contained in the Economic Equity Act.

The tax threshold for elderly Americans, too, should be higher than that for other Americans, because these individuals have less of an ability to pay because of their greater expenses. We are happy with the provisions in the Administration bill which seek to ensure this treatment.

In terms of dependent care expenses, this issue, too, is important to women because they bear the major responsibility for caring for dependents, in the case of both children and older or disabled dependents, and with more and more women entering the workforce, the responsibility of arranging for care of these dependents has fallen on them as well.

The greatest source of Federal support for dependent care right now is the dependent care tax credit. It is currently targeted to provide the greatest help to those at low and moderate incomes and the least help to those at higher incomes because of their greater ability to pay for these expenses themselves.

The problem with all of the major reform bills is that they change this targeting. The Administration bill and Bradley-Gephardt change the credit to a deduction, and Kemp-Kasten eliminates the credit or any recognition of dependent care expenses entirely. Bradley-Gephardt, by providing a 14 percent deduction for all taxpayers, lowers recognition of these expenses for everyone. The Administration, by tying the deduction to the marginal tax rates, lowers the recognition of expenses for low-income and moderate-income families and raises it for high-income families. This we find particularly unjustified.

The plans' sponsors say that the generally lower rates in their plans will compensate for this loss in dependent care expenses. The problem with that argument is that everyone is going to enjoy lower rates, but the people that have dependent care expenses will still have less of an ability to pay and so must continue to receive recognition of those expenses in the Code. Again, on this issue we support the provisions in the Economic Equity Act

Thank you.

The CHAIRMAN. Thank you.

Senator CHAFEE. Mr. Chairman, could I interrupt one moment?

The CHAIRMAN. Sure.

Senator CHAFEE. Unfortunately, I have to go an Environment and Public Works Committee meeting for a while, and this panel might be through by the time I get back. But I just would like to welcome our former colleague Floyd Haskell and also welcome Bob McIntyre, who as you know has been a worker in this vinyard for many, many years, a lone voice up here arguing for tax reform before it was terribly popular. So if this panel is through by the time I get back, I just wanted to welcome you both again, and of course the other panelists as well.

Senator HASKELL. Thank you very much, Senator Chafee.

Mr. McINTYRE. Thank you, Senator.
The CHAIRMAN. Ms. Forman.

STATEMENT BY MAXINE FORMAN, CO-CHAIR, COALITION ON WOMEN AND TAXES, AND DIRECTOR, POLICY ANALYSIS, WOMEN'S EQUITY ACTION LEAGUE, WASHINGTON, DC

Ms. FORMAN. Senator Packwood and members of the committee: I am very pleased to be here to discuss two extremely important equity issues, equity for two-earner couples and for single heads of household. I will discuss single heads of households first.

Single heads of households and married couples with the same income and family size should be treated similarly by our Tax Code. Under current law they are not. Most heads of households are single parents maintaining homes for dependent children. Now, in addition to difficulties of single parenthood—pay inequity and high unemployment—single women maintaining families are shouldered with an unfair tax burden which they cannot afford. Their median annual income is less than $12,000.

While household budgets vary slightly depending on the age of the householders and the children, the cost of a budget for a single parent family is very close to and in many instances is greater than the cost of a budget for a same-sized married-couple family. Now, although their household expenses are comparable, these families do not pay the same amount of Federal income tax. Heads of households pay more. For example, in 1984 a head of household with $10,000 of income, no special credits or deductions, and two dependents paid 35 percent more tax than a married couple with the same income and one dependent. This difference in tax liability is caused by the zero-bracket amounts and the tax rates schedules. Heads of households have the same ZBAs as single taxpayers without dependents. In addition, the tax rates for heads of households are higher than those for married couples filing jointly. To provide equity between heads of households and married couples would require use of the same ZBA and tax rates for both filing statutes.

S. 1169, the 1985 Economic Equity Act, raises the ZBA for heads of households to that for married couples.

Two of the three major tax reform proposals address the inequity I have described. Kemp-Kasten nearly eliminates the penalty on heads of households, while the Administration's proposal reduces the penalty to some degree. We support the intent of these measures, although neither achieves the goal of complete equity.

The Bradley-Gephardt proposal increases the penalty on heads of households—increases the penalty on heads of housholds. A head of household with an income of $10,000 and two dependents pays 448 percent more Federal income tax under Bradley-Gephardt than a married couple with the same income and one dependent. At $15,000 of income, the head of household pays over 70 percent more.

We think Congress should recognize the greater tax burden on single heads of households compared to married couple families and should equalize their ZBAs and tax rates.

Tax equity for two-earner couples is another concern. We feel the Tax Code must continue to give a tax deduction to married couples

where both partners are employed. This provision recognizes the greater nondeductible employment-related expenses incurred by two-earner couples than by one-earner couples and the effects of these expenses on their ability to pay.

The greater employment-related expenses of two-earner couples generally are for transportation, clothing, and in many instances Social Security. According to one study, two-earner couples spends over 17 percent more than a one-earner couple on employment-related expenses.

A related issue is the marriage penalty. Most two-earner couples pay more Federal income tax than two single taxpayers with comparable incomes. This marriage penalty occurs because the zero bracket amount for married couples is less than the combined zero bracket amount for two single taxpayers. Also, the progressive rate places a higher effective tax rate on a couple's second $10,000 of income than on a single taxpayer's first $10,000 of income.

Now, current law allows two-earner couples, even non-itemizers, to deduct 10 percent of the salary of the lesser-earning spouse, for a maximum deduction of $3,000. Without the deduction, the two-earner couple where each spouse earns $10,000 would have paid 15 percent more in Federal income taxes in 1984 than two single taxpayers with the same incomes. With the deduction, however, the penalty was reduced to 5 percent. Without the deduction, all married couples would be taxed alike. Such a move, that is a failure to recognize the two-earner couple's greater expenses appears to reward married women for staying out of the workplace. All of the major reform proposals repeal the two-earner deduction.

It is clear that even with the Administration's lower, flatter tax rate, a substantial marriage penalty would remain for many couples, especially at low and moderate income levels. Kemp-Kasten imposes similar penalties. Lower and moderate income couples can least afford this penalty. They are the same couples that lose the most if the dependent care tax credit is converted to a deduction, as several of the tax reform plans including the Administration's have proposed.

The Bradley-Gephardt proposal eliminates the marriage penalty for two-earner couples with incomes under $40,000 a year. It also gives many married couples increased marriage bonuses.

Let me conclude here. The two-earner deduction, as we know, was enacted after careful consideration. Congress felt that this was the best solution for a complex problem. The problem has not disappeared and does not disappear under any of the tax reform proposals. So, in our view, tax reform should not eliminate the current deduction for two-earner couples.

I thank you, and I look forward to working with you.

The CHAIRMAN. Thank you very much.

[Ms. Forman's written summary follows:]

WEAL
Women's Equity Action League

Specialists in Women's Economic Issues

SUMMARY STATEMENT

OF

MAXINE FORMAN

DIRECTOR, POLICY ANALYSIS

WOMEN'S EQUITY ACTION LEAGUE

ON

TAX EQUITY FOR SINGLE HEADS OF HOUSEHOLDS AND TWO EARNER COUPLES

FROM STATEMENT

OF TAX FAIRNESS FOR WOMEN

OF

NANCY DUFF CAMPBELL

MANAGING ATTORNEY

NATIONAL WOMEN'S LAW CENTER

AND

MAXINE FORMAN

DIRECTOR OF POLICY ANALYSIS

WOMEN'S EQUITY ACTION LEAGUE

BEFORE THE

SENATE FINANCE COMMITTEE

UNITED STATES CONGRESS

JUNE 19, 1985

1250 I Street NW, Suite 305, Washington, DC 20005 (202) 898-1588

Senator Packwood, members of the committee. Thank you for this opportunity to testify. I am Maxine Forman, Director of Policy Analysis at Women's Equity Action League. Testifying with me today is Nancy Duff Campbell, Managing Attorney of National Women's Law Center.

We are appearing together today, not only on behalf of our respective organizations, but also we co-chair the Coalition on Women and Taxes, a diverse group of women's, children's, religious, aging, civil rights and civic groups. We have been meeting since early in the year to analyze national tax policy as it affects women and to assess the various reform proposals and their impact on women.

We will be submitting for the record a statement on behalf of the Coalition which develops our positions in greater detail. Our summary comments today will address the tax threshold for low income women and families, equity for heads of households and two earner couples, and the Dependent Care Tax Credit. I will speak first on equity for heads of households and two earner couples.

TAX EQUITY FOR SINGLE HEADS OF HOUSEHOLDS

The principle of equity requires that single heads of households and married couples with the same income and family size be treated similarly by our tax code. Under current law single heads of pay more taxes than married couples with the same income and family size. This should be changed.

Most heads of households are single parents maintaining homes for dependent

children. 90 percent of single persons maintaining families with children under age 18 are women.

In addition to problems of single parenthood, pay inequity, and high unemployment, single women maintaining families are shouldered with an inequitable tax burden which they can not afford. The median annual income for single women maintaining families is only $11,789.

While household budgets vary slightly depending upon the ages of the householders and the children, the cost of a budget for a single parent family is very close to and in some instances greater than the cost of a budget for a same-size married couple family.

Although their household expenses are comparable, these families do not pay the same amount of federal income tax. Heads of household pay more. In 1984, a head of household with $10,000 of income, no special credits or deductions, and two dependents paid 35 percent more tax than a married couple with the same income and one dependent. The same head of household with $20,000 of income paid 19 percent more tax than a comparable married couple.

The difference in tax liability is caused by the zero bracket amounts (ZBAs) and the tax rate schedules. Heads of households have the same ZBA as single taxpayers without dependents. Because the ZBA tends to be most significant for lower income taxpayers, the tax penalty on heads of households compared to married couples generally is greatest for lower to middle income taxpayers. In addition, the intermediate tax rates for heads of households are higher than those for married couples filing jointly.

To provide equity between heads of households and married couples with the same income and family size would require using the same ZBA and tax rates for both filing statuses. Section 501 of the 1985 Economic Equity Act and H.R. 2477 raise the ZBA for heads of households to that for married couples.

Current Proposals

Two of the three major tax reform proposals address the inequity I have described. Kemp-Kasten nearly eliminates the penalty on heads of households, while the Administration's proposal reduces the penalty to some degree. We support the intent of these measures although neither achieves our goal of complete equity for heads of households.

The Bradley-Gephardt proposal increases the penalty on heads of households. A head of household with an income of $10,000 and two dependents pays 448 percent more federal income tax under Bradley-Gephardt than a married couple with the same income and one dependent. At $15,000 of income, the head of household pays over 70 percent more tax and at $40,000 of income she pays over 54 percent more tax.

Congress should recognize the greater tax burden on single heads of households compared to married couple families and should equalize their ZBAs and tax rates.

TAX EQUITY FOR TWO EARNER COUPLES IS ANOTHER CONCERN

The tax code must continue to give a tax deduction to married couples where both partners are employed. This provision recognizes the greater nondeductible employment-related expenses of two earner couples compared to one earner couples and the effect of these expenses on ability to pay. It also eases the so-called marriage penalty, under which two earner couples pay more federal income tax than two single taxpayers with comparable incomes.

The greater employment-related expenses of two earner couples generally are for transportation, clothing, and in many instances social security. According to one study a two earner couple spends over 17 percent more than a one earner couple on employment-related expenses.

A RELATED ISSUE IS THE MARRIAGE PENALTY

Most two earner couples pay more federal income tax than two single taxpayers with comparable incomes. This marriage penalty occurs because the zero bracket amount for married couples is less than the combined zero bracket amount for two single taxpayers. Also, the progressive rates place a higher effective tax rate on a couple's single $10,000 of income than on a single taxpayer's first $10,000 of income.

Current law allows two earner couples, even non-itemizers, to deduct 10 percent of the salary oof the lesser earning spouse, for a maximum deduction of $3,000. Without this two earner deduction, a two earner couple where each spouse earned $10,000 would have paid 15 percent more in federal income taxes in 1984 than two single taxpayers with the same incomes. With the deduction, however, the penalty was reduced to 5 percent.

Without this deduction, all married couples would be taxed alike. Such a move--a refusal to recognize the two-earner couples' greater expenses--appears to reward married women for staying out of the workplace.

CURRENT PROPOSALS

All of the major reform proposals repeal the two earner deduction. Hence none of the plans recognize the increased expenses of two couples and only one significantly reduces the marriage penalty.

Even with the administration's lower, flatter tax rates, a substantial marriage penalty would remain for many couples, especially those at low and moderate income levels. Kemp-Kasten imposes similar penalties. Low and moderate income couples can least afford an increased penalty. These are the same couples that lose the most if the dependent care tax credit is converted to a deduction as several of the tax reform plans, including the administration's propose.

The Bradley-Gephardt proposal eliminates the marriage penalty for two earner couples with incomes under $40,000 a year. However, it also gives many married couples increased marriage bonusses.

The two earner deduction was enacted after careful consideration. Congress concluded that the deduction was the best solution for a complex problem. The problem has not disappeared and does not disappear under any of the tax reform proposals. The tax system should not penalize taxpayers for either their marital or employment status and should take into consideration extra expenses that affect ability to pay taxes. In our view, tax reform should improve, not eliminate, the current deduction for two earner couples. Thank you, I look forward to working with you.

WEAL Facts

Women's Equity Action League
1250 I Street NW, Suite 305, Washington, DC 20005 (202) 898-1588

TAX REFORM: WHAT IT SHOULD DO FOR WOMEN

The federal income tax burden on women depends upon several factors including family, marital and employment status, source and amount of income, and age. Based on past reforms, some provisions recognize the different circumstances affecting women's ability to pay taxes. For the most part, however, the law does not adequately address the differences. For example, married women who are wage earners and single women who maintain families often bear unfair tax burdens based on their family status rather than their ability to pay. While women who are able to maintain a decent standard of living for themselves and their families have a responsibility to pay their fair share of taxes, for women in poverty there is no "fair share."

Several members of Congress and the Administration are currently advocating reform of the federal tax system. To help women to support themselves and their families and to redress the inequities of the current system which penalize women, tax reform must remain committed to the principles of exempting people in poverty from paying taxes, placing similar tax burdens on similarly situated taxpayers, and basing tax liability on ability to pay. WEAL advocates the following principles of taxation:

- Low income women should not be overtaxed; their efforts to become self sufficient through work should not be penalized.
- Single women maintaining families alone should not shoulder a greater tax burden than families with the same income and family size maintained by married couples.
- All women should be encouraged to continue and expand their economic productivity through the tax code's recognition of dependent care expenses and remedy for the marriage tax penalty.
- The tax code should continue to recognize the limited ability of most elderly women to pay taxes.

THE INCREASING TAX BURDEN ON THE POOR

The tax burden on the poor and near-poor has risen dramatically over the past several years. This burden falls disproportionately on women and children, who comprise three quarters of the nation's poor.

- In 1975, the level of income at which a family began to pay federal income tax, called the tax threshold or entry point, was almost 22% above the poverty level. By 1981, inflation had substantially increased the level of income needed to subsist at the poverty level, but the level of income at which families began to pay taxes stayed substantially the same. Thus, many families in poverty had to pay federal income taxes. In 1984, the threshold was 17% below the poverty level, and a family of four at the poverty level paid over $350 in federal income taxes.
- For most taxpayers, the tax threshold is the sum of the taxpayer's zero bracket amount, personal exemptions, and certain credits and deductions. The Earned Income Tax Credit (EITC), a refundable tax credit designed to offset a portion of the Social Security taxes paid by low income workers with children, is a key factor in the threshold of qualifying taxpayers. The EITC has been increased only 1% since 1968. The increase does not even account for inflation, let alone increases in Social Security taxes. Because the EITC is not "indexed" so that it automatically increases with inflation, the value of the credit will continue to erode.

<u>Tax reform should exempt families and individuals at or near the poverty level from paying federal income taxes.</u> This can be accomplished by substantially raising zero bracket amounts and the personal exemption, and increasing, expanding and indexing the EITC. Emphasizing zero bracket amounts and the EITC would assure that low income taxpayers get relief at relatively low cost.

HEADS OF HOUSEHOLDS

The IRS defines heads of households as single taxpayers who maintain a home for one or more dependents. The vast majority of single persons maintaining families are women. In addition to the problems of single parenthood, pay inequity, and high unemployment, single women maintaining families are shouldered with an inequitable federal income tax burden.

- Heads of households pay more federal income tax than married couples with the same income and the same size family. A head of household with an income of $10,000 and two dependents paid up to 34% more federal income tax in 1984 than a one-earner married couple with the same income and one dependent, even though the expenses of the families are roughly comparable.

Tax reform should modify provisions which cause heads of households to pay more taxes than married couples with the same income and family size. This can be partly accomplished by increasing the zero bracket amount for heads of households to that for married couples.

DEPENDENT CARE EXPENSES

Current law provides a tax credit for a portion of dependent care expenses necessary to enable the taxpayer to work. This provision benefits many two-earner couples and single women maintaining families, and recognizes the decreased ability to pay taxes of many taxpayers with dependent care expenses.

- The maximum credit, available to taxpayers with $10,000 of income or less, is only 30% of dependent care expenses up to a prescribed amount. Because the credit is not indexed to account for inflation, over time fewer and fewer taxpayers will have incomes low enough to qualify for the maximum credit. In addition, the limits placed on expenses, which are already inadequate in some instances, will become more restrictive as costs also rise with inflation.

- While the dependent care tax credit uses a sliding scale to give the greatest benefit to low income families, the credit often goes unrealized by these families because they have low tax liability and the credit is not refundable.

Tax reform should retain and improve the dependent care tax credit, especially as it affects low income families. This can be accomplished by expanding the current sliding scale, indexing the credit, and making the credit refundable.

TWO EARNER COUPLES

Married couples where both spouses work are allowed to claim a deduction from income of 10% of the salary of the lesser earning spouse up to $30,000. The deduction recognizes the increased nondeductible, employment-related expenses of two earner couples, and helps ease the marriage penalty under which two earner couples pay more income tax than two single taxpayers with comparable incomes.

- Two-earner couples generally have greater employment-related expenses than one earner couples, primarily for transportation, clothing, and Social Security taxes. According to one study, a two earner couple spends over 17 percent more on nondeductible, employment-related expenses than a one earner couple with the same income.

- Even with the deduction, many two earner couples pay more federal income tax than two single taxpayers with the same incomes.

Tax reform should retain and improve the current provisions which recognize the increased expenses of two earner couples and ease the marriage penalty.

ELDERLY WOMEN

Elderly persons, millions of whom are single women living on small, fixed amounts of income, are allowed greater levels of tax exempt income than other taxpayers. For example, persons with low and moderate incomes do not pay income tax on Social Security benefits. This exemption helps many elderly single women, one third of whom depend on Social Security for over 90% of their income. The increased tax threshold for the elderly recognizes their increased medical and personal care expenses which limit their ability to pay taxes.

Tax reform should retain the provisions which recognize the limited ability to pay taxes of most elderly women.

- -

Contact: Maxine Forman, Director of Policy Analysis
Patricia Blau Reuss, Legislative Director

Written by: Laurie Mikva
May 1985

Contents of this fact sheet may be reproduced provided credit is given to WEAL.

The CHAIRMAN. Let me ask first Mr. McIntyre and Senator Haskell an identical question. And let me preface it by saying I am always suspicious of statistics that are based upon the past as an example.

We are spending too much on defense because we have increased it $3 billion, $6 billion, $9 billion, $12 billion over last year. Then somebody will compare that to a social-spending figure that is less, as if the past was the base from which we should work, no matter what it was. And it assumes that the past basis is the accurate one. That isn't necessarily true. I see it in tax reform when people say, 'Corporations used to pay X percent of total taxes; now they are paying much less, and they should be paying more, as if what they paid before was what they should be paying.

So forget the past for a moment; I am curious, first, what proportion of the total Federal tax take do you think businesses should pay, and what should individuals pay? And I will lump businesses together as either corporate or operating in a noncorporate capacity, but business.

Mr. MCINTYRE. Well, Senator, if you include noncorporate I would guess the business total we would be looking for would be somewhere in the 25 to 30 percent range.

The CHAIRMAN. Floyd.

Mr. MCINTYRE. Excuse me, Senator?

The CHAIRMAN. Pardon me?

Mr. MCINTYRE. Excuse me?

The CHAIRMAN. No, I said "Floyd," because I sensed you were done with the answer.

Mr. MCINTYRE. I thought you said a number.

The CHAIRMAN. No, no. You said 25 to 30 percent total, counting noncorporate business.

Senator HASKELL. I don't really think that I am able to answer that question. I would say, however, that the past is some guide. As we all know, in the Fifties, I think it was somewhere around 7 percent from the corporate sector, and we prospered in the Fifties.

I would say this, however, that in thinking of the corporate sector, I thought Treasury-I very wisely—in the first place, they made the corporations pay the tax by getting rid of the preferences, and then they gave a credit for dividends paid. Now, that to my way of thinking was a very wise provision, because there certainly is double taxation if you tax the corporation in full and then that corporation declares dividends which are taxed to the stockholders. To the extent of those dividends, there is double taxation. So I thought that was very wise.

I think it is impossible for me to say, Mr. Chairman, what percentage of business as a whole, because there are no statistics on what unincorporated business had; there are lots of statistics on corporate businesses but none on the other.

But I would say a return to somerwhere in the neighborhood that Bob said is probably not too far off the mark. But, believe me, I am no expert on that.

The CHAIRMAN. A second question, and let's move to individuals. I will preface this by saying that, if we confiscate all of the individual income in this country above $100,000, and by that I mean a 100-percent tax on gross income, we will raise about $100 billion

once, because nobody is going to make over $100,000 the second year; that is the end of that goose, then we go someplace else.

But you both realistically know that great quantities of money cannot be raised by taxing the very wealthy; there just aren't enough wealthy.

Given that, given the fact that if we raise the taxes on them it is because it gives us a certain sense of fairness or equity or makes us feel good, even though it doesn't raise a lot of money, what should be the maximum effective rate on individuals?

Mr. MCINTYRE. Well, Senator, we think that for the income class over $200,000 you ought to be shooting for an effective rate of about a third, which I guess is considerably higher than what the Administration is asking for.

The CHAIRMAN. Well, they are asking for 35 percent.

Mr. MCINTYRE. Well, they are asking for what they say is an 18-percent effective rate.

The CHAIRMAN. Oh, you mean effective rate?

Mr. MCINTYRE. Yes.

The CHAIRMAN. All right. You are right. Go ahead.

Mr. MCINTYRE. We don't think that 33 percent is onerous; it is certainly by historical standards fairly low. We think it is also something well-off people could live with and that the American public in general can live with. You say there is not much revenue in taxing the upper-income groups. Well, we think there is a lot of revenue, billions of dollars, but it is more than that. You can't raise revenue from middle-income people unless they think you have a fair system.

The CHAIRMAN. Unfortunately, that is the only place, however, that you can raise great quantities of revenue, because that is where the great quantity of money is, is in the middle-income taxpayer.

Mr. MCINTYRE. Well, I don't know, Senator. In the current fiscal year, corporate tax expenditures are $120 billion. That seems to me to be a substantial sum.

The CHAIRMAN. Floyd, why don't you go ahead and comment?

Senator HASKELL. Certainly, Mr. Chairman.

I would think that a fourth bracket might well be added for those who are earning over $200,000. And maybe in the neighborhood of 45 percent, or something like that. And I do think it is terribly important that whatever is adopted be perceived as fair by the American people.

I would doubt that the American people would perceive as fair a same-rate for everybody from $70,000 up to $2 million, let's say. You know what I am talking about. And I don't think we ought to underplay the perception and fairness issue, because, as this Yankelovich Poll showed, people are finding a way around, using good old Yankee ingenuity, paying their taxes.

The CHAIRMAN. Let me ask you, Chuck, if I might continue, one more question. I think I have seen the same Yankelovich Survey you have and the Harris Survey. I think I have seen all the surveys that have been in the papers, and others, about what the public thinks, and fairness and unfairness. I have yet to see a poll where the public thought it was fair that their employee benefits be taxed. And yet you are suggesting, as best as I can tell from

your testimony, a rather significant tax on employee benefits or increased taxes on employee benefits. And as you are well aware, most of the major employee benefits are nondiscriminatory—you can't provide any more health insurance for the company president than you do for the janitor, or you can't provide any more daycare for the company president than you do for the janitor. Those are benefits that are very heavily skewed toward lower-income and middle-income taxpayers.

How do you square that fairness with their concept that it isn't fair to tax it?

Senator HASKELL. Well, I think this is the way. For instance, I think Treasury-1 is very fair. They basically didn't touch the pension system. They put a cap on health insurance at roughly $2,000 a year, which buys pretty good health insurance. And then they said, "No more fringe benefits."

The CHAIRMAN. And made taxable from dollar-one daycare, employer-provided education, employer-provided insurance—upon which there is a $50,000 cap now, but they would make it taxable from dollar-one.

Senator HASKELL. Well, Mr. Chairman, it's great if you have got fringe benefits, but the figures I have seen are that about 50 percent of the country's workforce has employer-paid health. About 24 percent has employer-paid pentions. The rest of it is a tiny percentage of the workforce.

So what I think you are doing, if you are opening the door to fringe benefits forever, you are going to create a two-tier workforce: the ones who are fortunate enough to have fringe benefits and not pay a tax—they are the elite—and then you have got the rest of the country who have to buy their own life insurance, their own childcare, and that kind of thing. So I really think that some line should be drawn where this can be tax-free, but no more.

I think, as you know, Mr. Chairman, the projections made by the Joint Committee are that fringe benefits tax expenditures go up much faster from here to 1989 than do, for example, the business tax expenditures.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. As long as the issue of fringe benefits came up, particularly health insurance, I would like to ask if any of you have views on what I consider the unfairness of the health insurance nondeductibility for self-employed people—the family farmer, the small main street business person. They do not have the ability to deduct their health insurance costs; whereas, if you work for a corporation, that is deductible as a business expense of the corporation.

Senator HASKELL. Well, Senator, I will answer that—I'm sure somebody else has an answer. You are pointing out what I was pointing out. The self-employed obviously are just one group of people that don't get fringe benefits, but there are an awful lot of employed people that don't get it. So you definitely have a discrimination, and you have to make a political judgment as to what is fair, and I think Treasury-1 drew a pretty good line.

Mr. MCINTYRE. Well, it is pretty hard to justify the distinction, Senator Grassley. I agree with you. I would like to say, however, that I don't think the reason that Americans are up in arms about

the tax system has much to do with fringe benefits one way or another, except maybe insofar as the Administration wants to tax them.

The CHAIRMAN. You are absolutely right if it's the same polls that Senator Haskell and I have looked at. I don't find anybody who thinks it's fair to tax them. If what you want is a perception of fairness, they think it is unfair to tax them.

Mr. MCINTYRE. That is why our testimony recommends dropping the Administration proposal there and focusing on what we think are the issues people care about.

Senator GRASSLEY. On another point I would ask more of a general question of Ms. Forman and Ms. Campbell, if I misunderstood, or whether if you made the point and I misunderstood it. I think you are not saying that, in the present proposal from the Administration, that poor people and particularly women are worse off than under present tax law but they aren't as well off as you feel they should be treated. What I missed, then, was the standard you might be seeking of that sort of fairness as the tax law would apply to people at the poverty or near-poverty level.

Ms. CAMPBELL. I am not sure I understand the question Are you focusing just on the threshold issue; in other words, the tax threshold?

Senator GRASSLEY. No, I wouldn't focus just on the threshold issue. I would interpret your point to be that probably people in lower-income levels are paying a higher proportion of federal tax in proportion to middle-income and high-income people than they should. But am I not right, you are also saying that whatever reforms we are considering, even the President's proposal, they are still somewhat better off than they are under present law but not as well off as you feel they should be, and what standard to you use, what do you seek as the ideal treatment of low-income people by our tax laws?

Ms. CAMPBELL. Well, I think you are right, they are definitely better off than they are currently, under all of the proposals really, and the Administration's probably goes the farthest in giving them assistance.

There are a couple of areas. One, I think I said that essentially they have gone back to restore the problem since 1981; but again, with all due respect to Senator Packwood, looking at the past and the level of taxation in 1979 is essentially where we have to go back, to that percentage. And going back to that level I think will better put them in a position where they were, where essentially all the poor were exempt from taxation and a very small percentage of near-poor were as well.

And specifically, we think you can juggle the personal exemption, the zero bracket amounts, and the earned-income tax credit, putting more into the zero bracket amounts and the earned income credit, so that the relief is targeted more on low-income individuals. And we would expressly support the Economic Equity Act provision sponsored by Representative Rangle in the House to improve the earned income tax credit, and the provision for the equalization of the zero bracket amount of heads of households and married couples, also contained in the Economic Equity Act.

Those are three things that need to be changed—back to the 1979 levels, expansion of the EITC, and equalization of those ZBA's.

Senator GRASSLEY. I am done with my questioning, unless you want to respond.

Ms. FORMAN. Well, I agree with that. The one issue that I would like to raise is that the two-earner couples are not necessarily better off under the proposals than they are under current law, and I mentioned that in my comments.

The two-earner couples under current law have certain appropriate tax treatments. Under the current law they have a deduction that would recognize some of their expenses for being a two-earner couple. And under the President's plan and under the other plans this deduction is eliminated. And therefore they are not better off in many cases than they are under current law.

The CHAIRMAN. Senator Long.

Senator LONG. Let me just say that I am glad to see my dear friend Floyd Haskell here again. I think I could have anticipated what your testimony was going to be; I have heard your views many times on the committee.

[Laughter.]

Senator LONG. And I am pleased to see your other witnesses here.

I am not going to ask any questions of the witnesses at this point, Mr. Chairman, but in reading their statements, I think they are logical and cogent statements. Thank you.

The CHAIRMAN. Let me ask Ms. Forman and Ms. Campbell if you have any comment about the quote we have heard bandied about in the paper, that the purpose of this tax bill is to help the traditional family—and the definition, of course, being the man who works and the woman who stays home to take care of the kids. Although, for the life of me, anybody who ever asks the question about, "Are you a housewife, or do you work?" does not understand what a housewife does.

Ms. CAMPBELL. Well, I think we agree with that, Senator. I think clearly the bill helps all families in many ways. The raising of the tax threshold is something that helps the traditional families, under that quotation, in other words where there is one earner, and also families where there are two earners. There are also expansions of assistance to elderly families, which may be "traditional" or not. There are expansions of the individual retirement accounts to give greater equity to one-earner families, and we support all of those provisions.

At the same time, the problem is that we think the bill does not provide equity to two-earner families, so in that sense it needs improvement, specifically in the treatment of two-earner couples, as we have described, and the treatment of dependent care expenses. So we want the bill to help all families, and we definitely support the reforms that help one-earner families we have discussed; but we think reform has to go further so that all families are treated equitably.

Ms. FORMAN. I would like to add something to that. The bill does help all kinds of families, and I think it should be very clearly stated that, although it does not go far enough with single heads of

household families, it takes a giant step, and that is really important.

Now, the EITC expansion helps all kinds of families, but about 50 percent of those who get the EITC are single heads of households. So the expansion helps single heads of households, and some one-earner couples, and I think a smaller number of two-earner couples.

Again, I would like to reiterate. The two-earner deduction is a real slight, in our view, the fact that it is going to be eliminated. If you look at all of the families that the President's plan helps, there is a definite inclination toward slighting the two-earner family and other families who have dependent care expenses, including the lower-income single heads of households. It is really a mixed bag.

The CHAIRMAN. In many areas, it is not bad—in many areas. But you are right on the two-earner families, for some—I don't know how many—it is a disadvantage.

Ms. FORMAN. Yes. And the turning upside down of the progressivity of the dependent care tax credit is also a problem.

The CHAIRMAN. In the deduction. I agree.

Ms. FORMAN. Oh, yes.

The CHAIRMAN. Let me ask you a philosophical question. I'll go down the line. And limit your answer to social policy, not business policy, not accelerated depreciation or investment tax credits.

You know the perpetual argument about whether we should use the Tax Code for incentives or just have straight-out government programs—"We'll tax you, collect the money, and spend the money on the programs we think are worthwhile." Which is the better way to achieve desirable social ends? The straight-out tax—you collect the money and spend it on the things we think are socially worthwhile—or the tax incentive approach?

Ms. CAMPBELL. Well, I will give sort of a philosophical answer and a practical answer. I think that philosophically it would be much better not to do it through the Tax Code and to do it through direct programs that can be targeted and can hit the individuals that we want to hit and give assistance to.

Unfortunately, we are not in that kind of an era, and the Tax Code hasn't been used for that. And I think, on behalf of our constituency, to the extent that the Tax Code is going to continue to be used in part for particular interests, we want our interests to be covered. And if that is where the action is, we want to get the most benefits for our constituency. So, philosophically, I think it would be better if we did not. I do not think that's the way tax reform is going to come out, and we want to make sure that our interests are protected.

The CHAIRMAN. Ms. Forman.

Ms. FORMAN. I tend to agree with that answer. I think it is inevitable that the Tax Code is going to make some social policy, because of the way our budget process goes. I think it seems to be easier to do it through the Tax Code, and I don't know that it is any more effective. I would like to see it done in a different way.

But I agree with Ms. Campbell that, as long as it is done this way, the Tax Code, in making policies that it does make, must recognize certain expenses, and differences and similarities in families, and ability to pay.

The CHAIRMAN. Interestingly, the best example—and I am going to ask Floyd and Mr. McIntyre to comment—and where we can compare both on this is probably in the area of health. For the bulk of the workers in this country we have tax-free, at the moment, employee benefits, and most people who work are covered by some kind of health plan. We also have Medicaid and Medicare; the latter being not quite as direct a government involvement as Medicaid, but you have a good comparison of different kinds of health deliveries. And the question, in my mind, is: Would the country be better off if, instead of the bulk of the workers being covered by employer-provided health insurance, we simply said, "No, we are not going to go that route; instead, we will make sure that they are covered by government-provided health delivery"? I don't know if that means we actually run it ourselves or contract it ourselves or what. But I think you have got three different systems with different mixes of government intervention, and you can try to conclude which you think is the best way to go about it.

Senator HASKELL. Well, in answer to your general question, Mr. Chairman, and then to the specifics, certainly by and large it is far better to have a direct appropriation than a sort of back-door tax thing that doesn't get reviewed, and we don't know who it is helping, and how much money, et cetera.

Now, there are exceptions. You mentioned health insurance. The figure that happens to come into my mind is that about 59 percent of the workforce have employer-paid health insurance.

I think Treasury-1 made a good, what I would say, practical or political compromise in that area, and allowed the basic health insurance—and so many people have it; 59 percent is a lot of folks—but put a cap on it.

And similarly, I think it is a wise decision to leave pensions, even though only 24 percent of any vested interest. I think that was a wise decision.

I think it is terribly unwise, however, to go beyond that in talking about fringe benefits, and I thought Treasury did a very good job. But certainly I think it is better public policy, by and large, to have direct appropriations. There are exceptions, but by and large.

The CHAIRMAN. Mr. McIntyre.

Mr. MCINTYRE. Senator, you asked the question whether the Tax Code should be used to make social policy, and you asked us to exclude the business and savings types of incentives.

The CHAIRMAN. I didn't want to get into the debate about the business end of it.

Mr. MCINTYRE. Right. Well, when you exclude those, you exclude most of the tax provisions that we object to. What is left is not very much policy at all; it is usually provisions designed to improve fairness, which we think is a good idea. If there is a social policy to the Tax Code, if you want to call it that, it is the idea that there should be some redistribution of income from those who have the most to those who have the least. The Tax Code can do that to some degree; it can't do the whole job, but it can do some. We are in favor of that.

The CHAIRMAN. And it certainly does it in the area of fringe benefits, and especially where they are nondiscriminatory so that the poorest employee gets the same as the richest employee.

Mr. McINTYRE. Well, fringe benefits when properly designed can do some of that. There are some problems with differing rates, as Senator Haskell would tell you.

The other question you raised is: Should we have a national health insurance program instead of the current system? Well, I'm no expert on health policy, but I think it would be worth spending more time thinking about, because a kind of national entitlement system like that might solve the problem that you were alluding to, about the fact that at the lower end of the income spectrum some of the current health programs don't seem to work as well as they should. If we start including some middle class people in getting those benefits, you can guarantee that there would be an outcry so that Congress would fix whatever was wrong.

The CHAIRMAN. Well, there might be an outcry. [Laughter.]

I am not sure Congress in its wisdom would necessarily know how to fix what is wrong.

An example, and Floyd will remember this from campaigning. You can go to your mills and your mines and the coffee shacks, and my hunch would be, Floyd, when you were campaigning you did not get many questions from the average worker about national health insurance.

Senator HASKELL. That is perfectly true.

The CHAIRMAN. They might have asked about gun registration, and out in Colorado they probably asked about gun registration a lot.

Senator HASKELL. And dams, water projects.

The CHAIRMAN. Oh, yes.

We lose about $30 billion a year in revenue a year by not fully taxing, from dollar-zero, health benefits—about $23 or $24 billion in income tax and 6 to 7 in Social Security. So that's $30 billion foregone in exchange for which we get a health insurance system—the figures I had, Floyd, were about 89 percent of employees in this country covered.

Senator HASKELL. I don't know.

The CHAIRMAN. I asked the Joint Committee to do a study for me on what it would cost the Federal Government to provide the same level of health benefits that employers now provide through the insurance but for which we forego $40 billion. The Joint Committee estimated about $100 billion, to provide the same level of benefits. So, if we did it, we would have to find $100 billion in taxes someplace, assuming we were going to pay for it on a tax basis.

Mr. McINTYRE. Well, the question, Senator, is what does it cost us now to run the current system? Do we get $100 billion worth of health care under the current system? It may be, because of frictional losses under the current approach, that it costs us $110 billion. And whether it comes out of our wages because our employers pay us less, or whether it comes out of our wages because the Government taxes us to pay for it, doesn't seem to me to be that significant.

The CHAIRMAN. Well, I have no more questions. Thank you very much; I appreciate it.

Senator HASKELL. Thank you very much, Mr. Chairman.

Mr. McINTYRE. Thank you, Mr. Chairman.

The CHAIRMAN. It is good to have you back with us.

Senator HASKELL. Thanks, Bob.

The CHAIRMAN. Now we have a panel with James Davidson, Chairman of the National Taxpayers Union; Joseph Goffman, Staff Attorney, Public Citizen's Congress Watch; and Peter L. Baumbusch, Treasurer, Fair Tax Foundation.

We will start with Mr. Davidson. Mr. Davidson, go right head.

STATEMENT BY JAMES D. DAVIDSON, CHAIRMAN, NATIONAL TAXPAYERS UNION, WASHINGTON, DC

Mr. DAVIDSON. Thank you, Mr. Chairman.

First of all, I want to thank you for the privilege of coming here to present the views of the 150,000 members of the National Taxpayers Union. We believe that fundamental tax reform is long overdue, and we commend you for your comments and efforts in that direction.

I should say, in trying to summarize our response to the President's program, that it is more or less, "Hip, hip," but no "hurray." We think it is a good idea to consider the tax structure in a comprehensive way, to figure out whether the system is costing our society much more than it raises in revenue for the government. And I believe that practially anybody who examines this issue would conclude that we could have a much more effective system, one which would do less to impinge upon economic efficiency and do more to leave the average citizen well off, and still fund the basic needs of the Government.

While I certainly would agree with the comments that you made earlier on in the last panel, it doesn't necessarily follow that we should look back over years past and say, "Well, if the corporate taxes produced a certain percentage in revenues in the 1950's, then they ought to produce the same percentage now." Corporate profits were a much larger percentage of national income in the 1950s than they are today.

So perhaps one of our first steps should be to try to improve the profitability of industries before we raise additional taxes.

Nonetheless, I think it is worthwhile looking back to see what—what in that out-of-town phrase is—the "secular trend' in our tax structure. And if you do that, you find something very interesting. Something not unique to us but is something that has happened in almost every industrial country, and that is that there is a tendency for the marginal rates to be come down. If you look in this country, they have come all the way down from 90 percent to 50 percent. That is a substantial drop. And yet, that reduction has not been sufficient to keep the tax loopholes, so-called, from expanding at a geometric rate. According to the best estimates, in 1987 there will be something like $400 billion-plus of "tax expenditures," so called.

Now, we think there is a good reason for this, and the reason is something that has been pointed out by somebody who is not an ideologue—or if he is an ideologue, his ideology is not what people might expect from somebody making this observation—and he is Francisco Forte, who is a professor of finance at the University of Turin. He is also a leading member of the Italian Socialist Party and a member of Prime Minister Craxi's cabinet. He has looked in

a comprehensive way at the tax structures of many countries and has come to the conclusion that we really have two choices in the modern world. We either lower effective tax rates through loopholes or lower marginal rates. One way or the other, we have that choice. The question we face as a country is whether we would rather lower the marginal rates explicitly, minimizing the distortion effects, or have lower marginal rates through loopholes which do involve a tremendous amount of economic distortion.

Our view is that it would be better to lower the rates explicitly. In that respect, I appreciate comments reported in the press that Chairman Packwood has made that it would be far better to have a 25 percent top rate than it would be to have the system that has been proposed by the President. We agree.

I think if we had a wand to wave, one of the policies that we would urge on the Congress would be to take something out of the book that Senator Symms and Senator DeConcini were trying to write, which is to create a system that does eliminate the distortions, insofar as we can tell. You would have a top marginal rate of 19 percent. And unlike the plan proposed by the President, it would effectively reduce the rates of taxation on capital and tend to shift taxation toward consumption. I think in a better world that that is what we would want to do; we would rather tax people on what they take out of society than on what they put into it. And if people are concerned about the progressivity question, those are things that can be answered in other ways.

Nonetheless, there are a couple of particulars that I would like to address in addition to my prepared testimony. One is that I think we need to better target the personal exemption. The personal exemption increase that the President has made is full of disincentives, not incentives.

It was discovered in the Nineteenth Century by the colonial powers, when they were trying to mobilize economic activity in Africa, that they could increase output by raising taxes at the lower brackets. I wouldn't suggest that we do that; but if we changed the President's personal exemption increase into a tax credit of $300 a person, we would end up saving a lot of money that could be used to lower marginal rates.

Another thing that I would suggest is that we probably ought to begin to tax Social Security receipts after individuals have gotten back, with interest, the amount they paid in, just as we treat all other types of pension income. The reason that Social Security was not taxed in the first place was a legal fear on the part of President Roosevelt's advisors that unless it was made a gratuity, it might not stand the test of Supreme Court legitimacy. Well, that issue has long since been put to rest. It seems to me that the zero bracket amount and other effective means exist to keep the poor from being taxed heavily on Social Security benefits. We could raise about $10 billion if we would tax the portion of Social Security benefits that comes to people as income, after they have gotten back what they have paid in.

The final comment I would make is: We have, with the local tax deduction elimination, an opportunity, if no other changes were made, to reduce the marginal rates down to about 30 percent. I think that would make it much more palatable for people, because

mainly high-income itemizers use this provision. A calculation made on the 1982 figure shows that, if we kept the tax system just as it was and reduced the marginal rate down to about 30 percent, it would have only yielded about $29 billion less revenue than it did at a 50-percent top marginal rate. Eliminating the deduction of state and local taxes in itself would practically finance that type of reduction. And I favor that.

Thank you.

[Mr. Davidson's written testimony follows:]

NATIONAL TAXPAYERS UNION

A NONPARTISAN, NONPROFIT ORGANIZATION DEDICATED TO THE PUBLIC INTEREST

325 PENNSYLVANIA AVENUE, SOUTHEAST WASHINGTON, DISTRICT OF COLUMBIA 20003 TELEPHONE: AREA CODE (202) 543-1300

Statement of

James D. Davidson

Chairman

National Taxpayers Union

before the

Committee on Finance

U.S. Senate

on

President Reagan's Proposal for Comprehensive Tax Reform

June 19, 1985

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear today on behalf of the 150,000 members of the National Taxpayers Union.

I commend you for your commitment to fundamental tax reform. Like the President, you have indicated your support for simplifying the tax code and bringing tax rates down. So have Senators Bradley, Roth, and many other members of Committee. We are pleased to see that the present tax reform effort appears to be bipartisan in character. This should increase the chance that we will see a rational restructing of the tax code, rather than a slap-dash political gesture that won't stand the test of time.

In this respect, I think it is important to take a longer view of the evolution of the tax system. This will show that comprehensive reform is now necessary to avoid massive and increasing distortions that cost our economy dearly, curtailing growth and reducing the number of jobs.

Marginal tax rates have been on a secular downtrend, not just in the United States, but throughout the industrialized world. Why? Not because polticians are now more eager than in the past to cater to the rich. Rates have been falling, but not fast enough, as a necessary response to tax avoidance and tax evasion. This has been explained by no less an authority than Francisco Forte, an important member of the Italian Socialist Party, Professor of Finance at the University of Turin, and now a minister in the Italian cabinet. Professor Forte has explained that lower effective tax rates, especially at the top, are essential not only to minimize tax avoidance and evasion, but to most effectively mobilize economic resources. The question, therefore, is whether to have lower marginal rates -- which improve incentives - or lower effective rates through loopholes and evasions -- which lessen economic efficiency.

An increase in nominal income has put many more individuals into high tax brackets. High taxes, by necessity, must be riddled with loopholes, in order to keep the economy functioning. These loopholes were originally designed to provide a boost to certain industries or to promote a social goal, but now serve to reduce effective tax rates in an era of high marginal taxes.

In spite of reduction in the top U.S. marginal tax rate from a high of 90% at the end of World War II to the present 50%, so-called tax expenditures, which represent a rough approximation for the use of loopholes, have mushroomed. According the the Joint Committee on Taxation, total tax expenditures amounted to $36.55 billion in 1967. The estimate for 1986 is $424.5 billion.

We strongly support simplifying the tax system and reducing tax rates. A well-designed reform must substantially reduce marginal tax rates while eliminating or curtailing tax deductions and credits.

My testimony today on President Reagan's tax plan is necessarily tentative. We are still canvassing our Advisory Board and our Board of Directors for their comments on the President's plan.

Our initial impression is that President Reagan's tax reform plan is an important step in the right direction -- an improvement on the current tax system. We would probably support its adoption in its present form, but we think it can be substantially improved.

As a point of comparison, we think the best fundamental tax reform proposal to date has been made by Stanford University economists Robert E. Hall and Alvin Rabushka. This plan has been introduced in the 99th Congress by Senators Dennis DeConcini and Steve Symms (S. 321). This comprehensive flat rate reform is breath-taking in its simplicity, fairness and efficiency. It's also the only flat-rate tax proposal to date to tackle the corporate income tax head on, something that must be a part of any major tax reform.

The Hall/Rabushka proposal rests on four basic principles: 1) All income should be taxed only once, as close as possible to its source; 2) All types of income should be taxed at the same rate; 3) The poorest households should pay no income tax; 4) Tax returns for both households and businesses should be simple enough to fit on a postcard or on one page.

The current personal and corporate income taxes would be replaced with an individual compensation tax and a business tax with the same low rate.

The individual compensation tax would apply to income received as wages, salaries, and pensions (when retired). The fringe benefits and pension contributions would not be taxed when received by the individual because they are nondeductible items under the business tax, and thus are taxed once in that system. The zero bracket amount and personal exemptions would total $12,600 for a married couple filing jointly with two dependents. No other deductions would apply for individuals. The only deduction that should be considered in such a system would be one for charitable contributions or medical expenses that exceed 10 percent of income.

As the authors note, the business tax would apply "equally to all forms of business — corporate, partnership, professional, farm, rentals and royalties. The base for the taxes is gross revenue less purchases of goods and services and compensation paid to employees. In addition, a capital recovery allowance is deducted for investment in plant and equipment. No deductions are permitted for depreciation, interest or payments to owners in any form." No deductions are permitted for fringe benefits paid to employees, except for pension contributions.

We believe the rate for the Hall/Rabushka tax plan should be no higher than 19 percent, which is approximately enough to replace the tax collections from the current personal and corporate income tax.

But we can, and will, support intermediate steps to a flat-rate income

tax. As such, President Reagan's plan is an improvement with many attractive features, including the following:

It reduces marginal tax rates for individuals and corporations. The top income tax rate for individuals would drop from 50% to 35%, while the top corporate tax rate would drop from 46% to 33%. Marginal tax rates for individuals would drop an average of 19%. The reductions in marginal tax rates and the reduction in the differential of tax rates for different investments allows for more efficient allocation of resources.

We believe this is the key to fashioni..g a tax system that will enable this Nation to prosper for the rest of the century. Without substantial tax rate reductions, economic distortions will continue to increase, slowing economic growth and reducing tax compliance.

Other features of President Reagan's plan will reduce impediments to economic growth. It reduces the maximum capital gains rate from 20% to 17.5%. It reduces the double taxation of dividends by allowing corporations to deduct 10% of their dividend payments.

The Treasury Department estimates that the President's plan would increase economic growth, expanding the Gross National Product by an estimated 1.5% when fully phased-in. A larger tax rate reduction would increase growth more. Economists Hall and Rabushka estimate that their flat-rate tax would increase the GNP by 9%.

It would increase government accountability. This would be especially true at the state and local government level. People who itemize deductions take a deduction for state and local taxes. This makes the burden of these taxes less for those who itemize. Not only is that unfair, it is unwise. State and local government programs should stand on their own merits, without a federal tax subsidy.

It would lift completely the tax burden on people below the poverty line.

It would also greatly reduce the income tax burden on the working poor, which may reduce the demand for high welfare benefits.

It could help reduce interest rates. Because the marginal tax rates for corporations and individuals would be reduced, there would be less incentive to borrow and more income received, after taxes, from lending. This should help reduce interest rates. In the past, the growth of consumer credit relative to assets has slowed when effective tax rates have declined.

It is less sensitive to inflation. Indexing of individual income tax rates and exemptions is retained. Indexing would apply for the first time to depreciation deductions for business. Starting in 1991, it would also be an option for computation of capital gains taxes. Indexing prevents taxpayers from being pushed into higher tax brackets when they receive a cost of living raise.

Indexing of depreciation deductions allows businesses to better plan their investments. Currently, the estimate of the value of depreciation deductions is based in part on the expectation of future inflation. Thus, the effective corporate tax rate is very much dependent on the future inflation rate. Indexing of depreciation deductions adds certainty to the corporate tax rate and will lead to better economic decisions.

Indexing of capital gains taxes prevents taxpayers from being taxed on fictitious, inflation generated increases in the value of an asset.

We would be unalterably opposed to a comprehensive tax reform bill if it did not retain indexing of the personal exemption and the tax rate brackets. One major comprehensive tax reform bill, the Bradley/Gephardt "Fair Tax," would remove indexing. As Table 1 shows, bracket creep would remain a severe problem under the "Fair Tax" proposal.

If inflation runs at 5 percent for five years, a family of four earning $15,000, with one wage earner whose income keeps pace with inflation, will

find their income taxes 63.8 percent higher than if the tax system had been indexed. A similar family making $25,000 would find their taxes 17.6 percent higher, while the family earning $40,000 would find their taxes 34.2 percent higher.

Table 1

Increase in Taxes Caused by Five Years of Tax Bracket Creep
Under the Bradley/Gephardt "Fair Tax"
Family of Four, One Wage Earner

1985 Adjusted Gross Income	1990 Adjusted Gross Income	1990 Tax Due	1990 Indexed Tax	1990 $ Increase	1990 % Increase
$10,000.00	$12,762.82	$218.79	$0.00	$218.79	N.M.
$15,000.00	$19,144.22	$1,112.19	$678.98	$433.21	63.8%
$20,000.00	$25,525.63	$2,005.59	$1,572.38	$433.21	27.6%
$25,000.00	$31,907.04	$2,898.99	$2,465.78	$433.21	17.6%
$30,000.00	$38,288.45	$3,792.38	$3,359.17	$433.21	12.9%
$35,000.00	$44,669.85	$5,246.16	$4,252.57	$993.59	23.4%
$40,000.00	$51,051.26	$6,905.33	$5,145.97	$1,759.36	34.2%

Source: National Taxpayers Union staff computations. All calculations assume that the proposal became effective in 1985 and that the annual inflation rate for 1985 to 1989 is a constant 5 percent. Calculations also assume that income is from wages, that the 1985 income grows at the annual inflation rate, and that no itemized deductions are claimed.

Inflation has a regressive effect on taxpayers under the Bradley/Gephardt proposal. Because the tax rate brackets are so widely spread apart, every taxpayer in the standard 14 percent tax rate bracket finds that the income tax increase caused by inflation is the same dollar amount. For example, after two years, the family of four earning $15,000 finds their taxes $160.72 higher, as does the family of four making $35,000. That's an increase of 27.4 percent for the lower income family, but an increase of only 4.4 percent for the higher income family.

How to Improve President Reagan's Tax Reform Plan

The Committee should improve the President's plan by further reducing tax

rates, closing more tax loopholes, and further simplifying the proposal.

Lowering marginal tax rates is by far the most important improvement which can be made. Among the leading tax reform plans, President Reagan's plan proposes the highest top marginal tax rate — 35%. Senator Bradley and Congressman Gephardt propose 30%, Congressman Kemp and Senator Kasten propose 28.8%, and Senators DeConcini and Symms propose 19%.

Lowering the top rate is important because it minimizes the attractiveness of the remaining tax loopholes. With the remaining deductions worth less, people will spend less time and money figuring out how to maneuver through the tax system. It also reduces the attractiveness of income shifting from year to year to take advantage of a lower bracket in a lower income year.

The easiest and most effective way to lower tax rates without rewriting President Reagan's plan is to better target the personal exemption. The rationale behind increasing the exemption is to permit families near or below the poverty line, to eliminate or reduce their tax. To low income earners, a personal exemption of $2,000 is worth at most $300 in tax savings, while it is worth $700 in tax savings for taxpayers who need it less -- the top bracket earners. This is silly.

It would be better to target the personal exemption by turning it into a tax credit of $300 for each personal exemption. This would fully retain the $2000 deduction value of the personal exemption for those families and taxpayers in the 15% tax bracket (15% x $2000 = $300), while effectively reducing the value of the personal exemption to $857 (35% x $857 = $300) for taxpayers in the 35% bracket.

I estimate this change would "raise" about $10 billion. This "gain" should be used to reduce the 25% and 35% tax rate brackets since taxpayers in these brackets bear the burden of this change. It's hard for us to estimate how far rates could be reduced, but our guess is that a reduction to 24% and 33% could

be financed with this one minor change.

Martin and Kathleen Feldstein estimate that this change would raise about $19 billion. If their estimate is correct, more rate reduction for the top two brackets would be possible.

They also propose "to limit the increase (in the personal exemption) to children and not to give any increase to adults." They estimate the revenue gain to be $25 billion which they propose to use for more across the board tax rate reduction.

Eliminating the personal exemption tax credit for taxpayers in the 35% bracket would raise another $2.5 to $3 billion. This alone is almost enough to finance a reduction in the top rate to 33%.

The first Treasury proposal taxed more sources of income, in particular fringe benefits. By 1990 it would have "raised" about $18 billion from including three types of fringe benefits as income. But the new plan only would raise roughly $4 billion by that time -- a loss of about $14 billion. The original Treasury proposal limited the exclusion of health insurance, but it would have provided a strong incentive for employers to provide for adequate health insurance for their employees. This health insurance "cap" would also help limit rising health care costs by limiting the tax deductibility of this fringe benefit. Special treatment of "cafeteria" plans and group term life insurance would have also been ended. This $14 billion of tax revenues could be used to further reduce tax rates across the board by at least another percentage point for each bracket.

Another important step that can and should be taken is to reduce the tax incentive for borrowing, particularly consumer borrowing. Curtailing the bias toward borrowing will lower interest rates and bring down the value of the dollar. We think that the fundamental reason that real interest rates are high is that total borrowing by business, government and consumers is now more than

153% of GNP. The last time it reached this level was just before the Great Depression. It would be prudent for the Congress to further curtail the tax incentives that have brought interest rates and borrowing to such dangerously high levels.

While the President's tax plan is not biased against heavy manufacturing, it does reduce the tax bias in favor of these industries. This will increase their cost of capital. Reducing the tax bias for borrowing will help these industries because interest rates and the value of the dollar will be lower. This will mitigate the damaging effects of eliminating the investment tax credit on these industries.

Conclusion

Income tax reform that substantially reduces tax rates could have many economic and social benefits. President Reagan's tax reform proposal would improve our tax system, but further improvements are possible. We hope the Committee will report a comprehensive reform plan for consideration by the Senate.

The CHAIRMAN. I have gone around asking people the question, What rate would you get the top bracket down to? Before, they didn't really care much about deductions, one way or the other.

Mr. DAVIDSON. Exactly.

The CHAIRMAN. Oh, 25-30, around in that area. At that stage you would remove a lot of the antagonism toward even further reform, because not many people would care about the deductions.

Mr. DAVIDSON. Absolutely. That's why we favor your suggestion.

The CHAIRMAN. Mr. Goffman.

STATEMENT BY JOSEPH GOFFMAN, STAFF ATTORNEY, PUBLIC CITIZEN'S CONGRESS WATCH, WASHINGTON, DC

Mr. GOFFMAN. Thank you, Mr. Chairman.

Public Citizen very much appreciates your invitation to appear here today, and we would like to commend you and the members of this committee for your responsiveness and receptivity to considering the issues of tax reform.

As you probably know, Public Citizen is the public advocacy organization founded by Ralph Nader in 1971, and its current membership is 80,000. I am a staff attorney with Public Citizen's Congress Watch, which is the lobbying arm of Public Citizen.

I am glad to be in a position to follow up on some of the remarks made by the first group of panelists this morning, because I think what they show is that 1985 has to be looked as the year of the average American taxpayer. I think this is going to be the year

that the ordinary working person will get what he or she wants from this committee and this Congress. After all, the popular perception is that all sorts of small groups and special interests have gotten what they wanted, and this is our year to show the average American that the political process, particularly the tax-law-writing process, can be responsive to his and her needs.

What the average American taxpayer wants is relief from a tax system that permits the General Electrics and the Lockheeds to earn hundreds of millions of dollars in profits without paying federal income tax, a tax system that permits something like 9,000 people who earn more than $250,000 a year to pay nothing in Federal income tax.

What the American taxpayer wants, also, is relief from a tax system that makes industrial policy by accident, in that it so distorts economic decisionmaking that the average business person or investor spends almost as much energy thinking about the Tax Code as about the most productive uses of investment resources.

In short, what the average American wants is real tax reform, so that all taxpayers, personal and corporate, will bear their just share of the tax burden, and so that it will be the market and not the Tax Code that determines the way our society's resources are allocated.

President Reagan has shown us an important first step in that journey toward tax reform. The President's plan gives some relief to the poorest taxpayers, it curtails a number of unwarranted corporate tax subsidies, and it does scale back several provisions that foster some of the worst Tax Code created distortions in the economy. In all, the President has given us a respectable miscellaneous Tax Code improvement act, but it is not yet close to real tax reform.

To give the ordinary American taxpayer the true tax reform that he and she want, this committee will have to surpass the Reagan plan; this committee will have to follow the example of the anonymous authors of last November's Treasury proposal and of Senator Bradley and Representative Gephart, and turn a deaf ear to the special interests in order to bring an end to economic distortion and tax avoidance by the rich and the profitable.

Let me just hit on a couple of examples. We feel that true tax reform legislation must provide for a business depreciation system that resembles the one that was put forward in the Treasury plan and not the one in the Reagan plan. The President's CCRS depreciation proposal is an unmitigated bonanza for business. The President's plan even announces this because it unabashedly congratulates itself for lowering effective tax rates, for corporations in particular. As a result, the President's depreciation scheme would foster massive corporate tax avoidance, perpetuate significant distortions in investment decisionmaking, and build a huge revenue-losing hole into the Tax Code, a hole that we fear would do nothing but add to the budget deficit.

At the same time, true tax reform legislation will not include a capital gains preference like the President's plan now does; instead, it will treat capital gains as ordinary income. Like incentive depreciation, capital gains preference distorts economic decisions and

permits significant tax avoidance, and it is of vastly disproportionate benefit for the rich.

The President's plan, unfortunately, offers a troubling example but a useful one of how special interest politics can frustrate the true tax reform that Americans want. The President's plan gives families earning between $20,000 and $60,000 a year a $150 yearly tax cut, on average, which works out to a little less than $3 a week. At the same time, the plan also gives those who earn more than $200,000 a year a $9,200 yearly cut. We don't think that is anybody's idea of real tax reform. That $3 is not enough to sell the American people on a tax code that would continue to provide tens of billions of dollars in depreciation and capital gains giveaways for big business and the rich.

In conclusion, Mr. Chairman and members of the committee, this committee must rise above the limitations that both the Reagan plan and the special interests would impose on its work, and give the American people true tax reform.

Again, thank you very much for having us here.

The CHAIRMAN. Thank you.

Mr. Baumbusch.

[Mr. Goffman's written testimony follows:]

STATEMENT OF

JOSEPH GOFFMAN

STAFF ATTORNEY

PUBLIC CITIZEN'S CONGRESS WATCH

CONCERNING

REFORM OF THE FEDERAL INCOME TAX

BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

WEDNESDAY JUNE 19, 1985

Mr. Chairman and Members of the Committee: Public Citizen very much appreciates the opportunity to testify today on the subject of tax reform. Public Citizen, supported by 80,000 grassroots members, is the public advocacy organization founded by Ralph Nader in 1971. I am Joseph Goffman, an attorney with Congress Watch, the legislative lobbying arm of Public Citizen.

INTRODUCTION

As an advocate of tax reform, Public Citizen has long sought to promote the interests of the average American taxpayer. We have traditionally favored a tax code that ensures that all taxpayers, both individual and corporate, bear their just share of the collective tax burden. In addition, we believe that the tax code should be economically neutral and not the vehicle for an unexamined, covertly carried out industrial policy. To these ends we have advocated a broadly defined tax base and a high degree of progressivity in effective tax rates and we have also consistently opposed tax-expenditure subsidies for corporate activity.

We have attempted to measure The President's Tax Proposal to the Congress for Fairness, Growth and Simplicity ("Reagan Plan") against these principles of just burden-sharing and economic neutrality.* Our preliminary analysis persuades us that the

---

* Our analysis is not complete and we ask the Committee's permission to supplement our testimony, if necessary.

Reagan Plan represents a significant improvement of the federal tax code, but it is not tax reform. If enacted it would provide tax relief for the poor and for lower-income taxpayers. Its treatment of the investment tax credit, the acceleration aspects of depreciation, the definition of capital assets and the deductibility of interest payments would correct to a significant extent the economic distortions now wrought by the tax code. Moreover, the Plan calls for the elimination or limitation of a host of industry-specific tax subsidies and preferences. Finally, the Plan appears to effect a modest shift in the tax burden from individuals to business. For these improvements, the President deserves our applause.

At best, however, the Plan might justify the name, The Miscellaneous Tax Improvement Act; to call it tax reform would be an outright deception, because with its "incentive" depreciation system, its retention and expansion of a capital gains preference, its perpetuation of tax breaks for the oil and gas industry, its preservation of a number of tools for tax shelter-building, and its generous tax cut for the rich, the Plan bears the authorial stamp of special interests and not of tax reformers.

Indeed, the measures adcpted by the Administration in tranforming last November's Tax Reform for Fairness, Simplicity, and Economic Growth ("Treasury Plan") into the Reagan Plan favored business and the rich over the average, middle-income

taxpayer, and were clearly the work of the President's special interest allies and not the champions of tax reform who produced the Treasury Proposal.

As a result, it is up to the Committee to seize a unique opportunity to achieve true tax reform. Notwithstanding the inadequacies in his own plan, the President is in the process of kindling widespread enthusiasm for true tax reform among an American public that in poll after poll reports its keen awareness of the unfairness of the current tax system. Such enthusiasm will be an indispensable political tool for bringing about tax reform. At the same time, that enthusiasm will change into deep outrage if the demand for tax reform is not met and the principles of tax reform are betrayed in any way, including in the way that the Reagan Plan betrays them. It is critical that this Committee not fail.

To succeed, the Committee must wage a campaign on two fronts. First, it must not yield to the myriad special interests who would reverse the improvements made in the Reagan Plan, for those improvements are worth the struggle and should be defended vigorously. At the same time, though, the Committee must correct the defects of the Plan and fashion its own legislation that will embody the principles of justice and neutrality upon which real tax reform is based.

Fortunately, it has before it two documents that will short-cut the process of putting together such legislation. By looking to the Treasury Proposal unveiled last November and to the

Bradley-Gephardt Fair Tax, the Committee has the blueprints and the materials for building genuine tax reform legislation.

I. The Need for Tax Reform

A. Justice and Taxpayer Morale

In 1974, a poll conducted by the Advisory Council on Intergovernmental Relations found that Americans considered the federal income tax the fairest of all taxes; today they consider it the least fair. In a poll commissioned by the Internal Revenue Service, four out of five of the people surveyed expressed the conviction that the tax system is unfair because it benefits the rich but not the ordinary citizen. Seventy-four percent believed that people cheat on their taxes because the "system is unfair." The American tax system is uniquely built on voluntary compliance. People pay their taxes because they respect the authority of the tax system, but without fairness--without each taxpaying person or entity bearing the appropriate burden--the tax system forfeits that authority. It is, therefore, not surprising that 19% of the surveyed taxpayers admitted to cheating. As a result, the Treasury lost $90 billion in unpaid taxes in 1981 (the last year for which figures are currently available) and the IRS projects a steady increase in that figure. What we have, then, is a simmering taxpayer rebellion. The key to solving it is not simply to offer token tax cuts to middle-income taxpayers, but to restore the principles of fairness upon which the authority of the tax system rests. As Ronald A. Perlman,

Assistant Treasury Secretary for Tax Policy has said: "People are expressing the view not that they're paying more tax ... but ... that they don't think they're taxed fairly."

Tax system injustice is blatant. In its well-known, shocking study, Corporate Income Taxes in the Reagan Years, Citizens for Tax Justice revealed that between 1981 and 1983, 128 of our biggest, most profitable corporate giants paid no taxes and/or received a tax refund in at least one year. At the same time, the Treasury estimated that in 1983, 9,000 people with incomes greater than $250,000 paid no taxes. The four out of five people who reported that the tax system was unfair certainly knew what they were talking about. What is more, the failure of profitable corporations and rich people to bear their just burden of taxes imposes a real, additional burden on the rest of us: if corporations were paying taxes at the rate they did in the 1960's, the current deficit would be half of what it is now. The shrinkage of the corporate tax share from 25% in the 1950's and 1960's to 6% to 8% in the 1980's has thus had real and terrible consequences for this country.

The first indispensable element of tax reform, then, is ending tax avoidance by rich people and profitable businesses. The tax code should be designed to collect revenue from each entity according to ability to pay; it must not include subsidies, particularly when, as now, it is primarily the rich and profitable who can best take advantage of these subsidies.

B. Economic Neutrality

To be coherent, tax reform must carry out one particular economic idea: it is the free market and not the tax code that is the more economically efficient allocator of resources. The current code, riddled as it is with countless tax preferences, has long since proven its inferiority as an allocator. According to the Economic Report of the President (February, 1985), p. 78:

> The result of all of these special features [in the tax code] is an extraordinarily complicated system that affects the return to labor supply, saving, investment, and myriad other activities. By altering the relative returns to various activities, the system diverts resources into less productive but more tax-favored activities. Consequently, the country wastes a substantial fraction of potential national income. Some of this waste is unavoidable under any income tax system; much of it, though, results because the system has strayed so far from a pure income tax concept.

The sheer misguidedness of tax code allocation is legendary, with, for example, cities like Houston drowning in enough vacant commercial office space--built by tax-motivated developers-- to house all of the commercial office space occupants in Philadelphia. At the same time, the tax code is powerless to effect even its crudest objectives such as stimulating investment. In The Failure of Corporate Tax Incentives, Citizens for Tax Justice found that from 1981 to 1983 the 50 largest, most profitable companies who benefited most from so-called tax incentives by paying little or nothing in taxes actually reduced their investments. At the same time, the 50 companies in the study which had the highest effective tax rate during that period increased their investments. Not only is this industrial policy a failure in terms of its economic results, but it

represents a serious corruption of the political system since it is formulated in virtual secrecy and carried out covertly:

> The tax code effectively guides the allocation of capital, overriding private market factors and the individually expressed consumer preferences they represent. This undeclared government industrial policy has grown dramatically in scale and yet it largely escapes public scrutiny or systematic review.
> Treasury Proposal, p. 57.

The second indispensable element of tax reform is ending the process of industrial policy-making by tax code. Thanks to the tax code's so-called incentives which "divert resources into less productive but more tax-favored activities," our present economy forces those who would pursue the most productive market-guided activities to compete for capital and other resources with those who would use them to pursue less productive tax-favored activities. Without such pointless competition, the cost of capital and other resources would surely fall and the productivity of the economy would surely rise.

C. Tax Shelters

The tax shelter plague and its cure crystallize the issues and principles of tax reform. Tax shelters are exclusively the creatures of the spate of "incentives" in the tax code. Since they exist to create on-paper losses by which taxpayers can shelter from taxation other, real income, they are almost by definition non-productive--or substantially less productive--than investments that are made for the purpose of profit not tax avoidance. At the same time, tax shelters are virtually in the

exclusive domain of the rich, who use them to avoid paying taxes they would otherwise owe.

Tax shelters combine the supposed incentives in the tax code, like depreciation, the investment tax credit, the interest deduction for borrowed money, the capital gains preference and the myriad industry-specific tax-breaks in the code to create losses on paper which taxpayers can use to reduce their tax bills. Tax shelters are a real growth industry. From 1976 to 1983, public sales offerings of tax shelters grew at an average yearly rate of 55 percent while new public offerings of common stock grew at a 31 percent rate and new business incorporations at a 7 percent rate. In 1983, at least $49 billion were invested in tax shelters and as much as $65 billion may have been invested in 1984.

The Treasury itself estimated that tax shelters cost it $17.5 billion in tax revenue in 1983 and some analysts project that that figure may have jumped to $24 billion in 1984. The beneficiaries of this tax code largesse were, of course, the rich. Eighty-two percent of the benefits of tax shelters went to people whose income exceeded $100,000. The 9,000 people mentioned earlier whose incomes were more than $250,000 and whose tax bills were zero used tax shelters to negate their tax obligations. At the same time, without tax shelters, the annual tax bill for the average American taxpayer could be reduced by about $300.

Tax shelters are diverting investment capital from its most

productive uses and are interfering with the economics of specific markets such as farming and real estate. Because tax shelters seek "losses," they can support business practices that the market would not bear, such as over-paying for real estate or over-producing farm commodities.

According to the Department of Agriculture study, The Effect of Tax Policy on American Agriculture, tax shelters have boosted the price of farm land, decreased the population of working farmers who own their own land, made it more difficult for young farmers to buy land and created incentives for farming practices that make for good shelters but encourage abuse of the land and natural resources.

Real estate tax shelters account for almost half of all sales of commercial properties. Because shelters seek tax losses not profits, tax shelter buyers are willing to pay more for property than investors who cannot exploit the tax shelter benefits. Analysts state that shelters have inflated the commercial property prices by 20 to 25 percent and investment property prices by 30 to 35 percent. At the same time, real estate shelters have created market gluts in a number of regions. In 1980, the national vacancy rate for office space was 3.8 percent; today it is 16.7 percent. In Houston, the vacancy rate is 20.9 percent and in Denver it is 27 percent.

Tax shelters epitomize both the injustice and economic wastefulness of the tax code; one of the measures of a bill's

claim that it is true tax reform is its success in eliminating tax shelters.

III. Real Tax Reform

A. The Packwood/Finance Bill

The Reagan Plan is no more than a miscellaneous act that would bring some specific improvements to the current tax code. Public Citizen is convinced that these improvements would be vital and would justify full support. The Reagan Plan, however, is not tax reform. If it is enacted it would still leave in place a tax code that continued to work distortions on the economy by means of so-called incentives. Problems of substantial corporate tax avoidance would remain as would significant unwarranted tax code subsidies for business activity. In addition, the plan extends the Administration's continued attack on progessivity.

If we are to have genuine tax reform legislation this year, then it will have to be the work of this Committee. Public Citizen strongly urges the Committee to draft its own proposal. Certainly, the Reagan Plan can serve as a starting point, but more important, the Committee should be closely guided by the work of true champions of tax reform: Senator Bradley, Representative Gephardt and the anonymous authors of the Treasury Proposal unveiled last November. The latter document in particular provides both a model of a viable tax reform plan embodying the principles of justice and neutrality and a rough

standard by which to examine other proposals, including the President's.

Using these models, Public Citizen presents below its views on selected key provisions that would have to be a part of any tax reform legislation this Committee produced.

B. Depreciation

The first test of any tax code's faith in the market as the most productive allocator of capital and resources is its capital cost recovery system. It is here that the tax code may be most vulnerable to the siren song of "incentives." The current Accelerated Cost Recovery System ("ACRS") was created in 1981 specifically to introduce substantial new economic incentives. No more eloquent an indictment of ACRS can be found than that included in the Treasury Proposal, at pp. 156-157:

> The low or negative effective rates on ACRS property and the tax deferral resulting from accelerated depreciation allowances distort investment decisions in a variety of ways. First, ACRS disproportionately benefits capital-intensive industries and methods of production. Income from sectors of the economy without significant investment in depreciable property typically face higher effective tax rates. Second, ACRS favors existing businesses over new, start-up businesses, and tax paying businesses over those with tax losses. Accelerated cost recovery allowances are more likely to be used fully by established, profitable businesses than by new companies with substantial start-up costs or by loss companies without net income. The potential unavailability of ACRS benefits may in turn lead to tax-motivated acquisitions or combinations that permit the benefits to be used fully in the year incurred.
>
> Finally, ACRS has fueled the growth of tax shelters. The low or negative effective tax rates on ACRS property, especially in the early years of acquisition, make possible the sheltering of an investor's unrelated income and the accompanying

> deferral of tax liability. This encourages taxpayers to make otherwise uneconomic investments in order to obtain tax benefits. Also, the prospect of substantial up-front deductions encourages excessive churning of assets.

In addition, analysts have demonstrated that ACRS favors equipment acquisition over new job hiring and occasions massive business tax avoidance.

The Treasury Proposal managed to discuss its Real Cost Recovery System ("RCRS") without once talking about "incentives." Moreover, it was here that the Proposal expressly rejected the tax code as an allocator of resources along with its "undeclared government industrial policy." Treasury Proposal at p. 157. Instead, the Proposal set forth a system to account for the "real economic loss inherent in the use of assets over time." Id.

Public Citizen urges the Committee to adopt a real economic depreciation system modelled on RCRS. Like the authors of the Treasury Proposal, we believe it is essential that the depreciation system neither produce any significant reduction in statutory rates nor create variations in effective tax rates among differing assets and industries. Treasury Proposal, p. 162.

The Reagan Plan would enact a depreciation system that would improve upon ACRS by reducing the economic distortions ACRS now creates. Specifically, the Reagan Plan, like RCRS, would classify assets for purposes of their recovery periods in a way that more accurately reflected their actual depreciation. This would partially equalize the net effect of depreciation on the variety of depreciable assets and largely, but not completely,

eliminate the inefficiencies in resource allocation that ACRS creates. By extending recovery periods and minimizing the "front-loading" effects of ACRS, the Reagan Plan would render depreciation a somewhat less useful tool to a tax-shelter builder.

Even with these features, however, the Reagan Plan's depreciation system is more distorting in its economic impact than the Treasury Plan's RCRS as it would continue to yield divergent effective rates on different types of assets. See Reagan Plan, p. 159.

What is more critical, is that at a time when even steel industry analysts acknowledge that "the availability of capital is more important than tax law for industrial planners" (Wall Street Journal, 5/30/85, p. 10.), the creators of the Reagan Plan betrayed completely the Treasury Proposal's resistence to "incentives." The Reagan Plan's discussion of its Capital Cost Recovery System ("CCRS") is riddled with references to "incentives" that would be highly costly in terms of tax expenditures. The present value of most assets under CCRS would be higher even than under ACRS, reflecting the generous deductions business would enjoy during virtually every year of the extended recovery periods provided under CCRS. The Plan hardly disguises that the "incentives" in CCRS are intended to create generous tax subsidies for business. While the Treasury Proposal's RCRS expressly sought to minimize the gap between

statutory and effective tax rates (Treasury Proposal, p. 162) the Reagan Plan omits any reference to the problem of corporate tax avoidance by means of depreciation (Reagan Plan, p. 148). In fact, the Reagan Plan frankly states that the CCRS depreciation allowances "would be more valuable than accelerated ACRS depreciation allowances," and "would produce ... lower ... effective tax rates" than either current law or the Treasury Proposal. Reagan Plan, p. 149. Thus, while the Treasury Proposal's depreciation system would have increased revenues by $213 billion in the first five years, the Reagan Plan would raise only $38 billion in that period and would lose revenue thereafter.

The Reagan Plan's inclusion of a rate differential recapture provision for taxes deferred through ACRS is critical to maintaining fairness. Regardless of the depreciation system adopted to replace ACRS, it is essential that companies that benefited from depreciation deferrals under ACRS pay their deferred taxes at the rate prevailing at the time of initial deferral and not at the new lower rate.

Unfortunately, this provision serves to disguise the tax avoidance consequences of CCRS. While the recapture provision would curtail some of the corporate tax subsidies created by CCRS in the very short run, that is, until 1988 or 1989, it must not obscure the fact that the Reagan Plan would retain at least 80% of the current annual $80 billion depreciation subsidy in the short run and would actually increase the corporate subsidy in

the long run. Moreover, the recapture provision permits the Reagan Plan to overstate significantly the shift in tax burdens from individuals to business. The estimated 22 percent short-run increase in corporate taxes appears to include the $60 billion expected under the recapture provision. By definition, though, this is only a transaction device, not a permanent part of the tax code. As a result, the shift in taxes from individuls to corporations built into the structure of the tax code by the Reagan plan would be substantially smaller.

CCRS turns tax reform upside down by creating a system of enormous corporate tax subsidies. It is essential that the legislation produced by this Committee reject CCRS and incorporate a depreciation system free of both economic distortions and opportunities for corporate tax avoidance.

C. Capital Gains

Once again, the Treasury Proposal, echoing the views of leading economists, such as Harvey Galper and Henry Aaron of the Brookings Institution, provides the clearest statement of the problems of distinguishing capital gains from ordinary income:

> Neutrality. The preferential tax rate for capital gains also distorts investment decisions by providing a potentially lower effective rate of tax on assets that offer a return of income such as dividends or interest. Along with other provisions that establish special tax treatment for particular sources and uses of income, the preferential tax rate for capital gains is one of an elaborate series of tax incentives for particular businesses and investments. These incentives impede the efficiency of an economy based on free market principles. This undeclared government industrial

> policy largely escapes public scrutiny, yet it increasingly controls the form and content of business and investment activity.
>
> Simplification. The sharp distinction in tax rates under current law between capital gains and ordinary income has been the source of substantial complexity. Application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. A significant body of law, based both in the tax code and in judicial rules, has developed to deal with these matters. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case. The taxpayer and the Internal Revenue Service resources consumed in this process are substantial, yet there is little basis for confidence that the results derived in particular cases are even roughly consistent. Treasury Plan, pp. 180-181.

Here, too, the Committee should reaffirm its faith in the market, rather than the tax code, as the superior allocator of resources. If the Committee sustains this faith with regard to the rest of tax reform legislation, then no economic benefits will be lost by taxing capital gains at ordinary income rates. As the Treasury Proposal stated at p. 186, for example: "the enactment of measures to reduce the advantages of investment in unproductive tax shelters, should increase the supply of capital available to high technology industries."

In addition to eliminating another tax-created distortion in the economy, erasing the distinction between capital gains and ordinary income would redress a critical unfairness in the tax system: the capital gains preference is of primary benefit to the rich and is a device for tax avoidance. According to Statistics of Income, 1982, 42% of all capital gains benefits enjoyed by

individuals benefited the top 1% of the population, those with adjusted gross incomes in excess of $200,000. On the other hand, only 15% of capital gains tax benefits went to the 68% of taxpayers whose incomes were less than $20,000. By rejecting the Treasury Proposal's replacement of the effective rate differential between capital gains and ordinary income with indexing, the Reagan Plan again demonstrated its bias in favor of rich taxpayers. Indexing clearly favors those who hold assets for long periods of time (and, presumably, depend on ordinary income like wages) as opposed to those who trade their assets (i.e. stocks and bonds) frequently (and, presumably, derive a large portion of their income from these transactions). The preferential rate, by contrast, is much more useful to this latter group. Studies have shown, in fact, that replacing the preferential effective rate with indexing would reduce capital gains taxes for the lower half of taxpayers, while increasing them for the richest taxpayers. Moreover, the capital gains preference is often the crowning element of the tax avoidance devices used in tax shelters whose major beneficiaries are the rich.

Admittedly, the Reagan Plan makes some beneficial adjustments to current law's capital gains provisions. By defining a capital asset more narrowly and excluding depreciable property, the Reagan Plan would blunt capital gains as an instrument of tax shelter building and curtail tax subsidies to

specific industries that currently exploit the preference.

However, the Reagan Plan's attempts to justify its reversal of the Treasury Proposal reveals the illogic of perpetuating the preference. Once again, the Reagan Plan betrays the faith in the market as resource-allocator that was the foundation of the Treasury Proposal. First, the Plan asserts a telling self-contradiction by contending that the preference is necessary to encourage investment in "innovative activities that involve high risk yet offer large economic and social returns." Reagan Plan, p. 167. No explanation is offered as to why the "large economic returns" of such investments are themselves not enough to stimulate investment without the assistance of the tax code.

The President and other defenders of this anti-market "incentive" point to its role in promoting venture capitalism. Their position, however, is completely undercut by the Treasury Proposal and recent economic history. In discussing its provision for indexing capital assets and taxing them at ordinary income rates, the Treasury Proposal observed:

> Moreover, a maximum marginal tax rate of 35 percent on indexed gains would produce effective rates that are not substantially above those experienced during the last two venture capital booms. (Tax rates of 25 percent during the 1960s and 28 percent from 1978 to 1981 on nominal gains were actually higher effective rates due to inflation.) In addition, all investors would continue to benefit from the deferral of tax on accrued but unrealized plans.
> Treasury Proposal, p. 186.

In addition, the most recent boom in venture capital was simply not affected by the tax code. The single biggest contributor to

the recent venture capital boom has been the influx of investment by pension funds, which, following recent changes in pension management risk standards, accounted for about 33 percent of venture capital in 1984. Lured by the strength of the dollar, foreign investors have provided the second biggest source of venture capital, contributing to 18 percent of the total in 1984. Neither pension funds nor foreign investors pay federal income taxes; by definition, their investment decisions were unaffected by the tax code. Moreover, most of the rest of venture capital came from sources like banks, insurance funds, university endowments and private corporations that would have paid taxes at an extremely low effective rate regardless of their involvement in tax-favored venture transactions. According to Michael Barker of the Gallatin Institute:

> Only a small and declining share of the money going into venture capital, about 19 percent over the last five years, was coming from private investors who are subject to the capital gains tax. And that percentage is down to 15 percent today.

Even for that 15 percent who are taxed, it is clear that the abolition of the capital gains preference would not alter their investment behavior: a Gallatin Institute study demonstrated that the average return on a venture capital investment is currently 77.7 percent.

As for the entrepreneur or venturer, Assistant Treasury Secretary Ronald A. Perlman has said: "I'm not at all sure that the true entrepreneur cares about whether it's capital gains or not capital gains. The inventor, the fellow in his garage doing

hic thing, is doing it for a different reason than whether his ultimate return is going to be taxed at 25 or 35 percent." New York Times, "Your Taxes," 3/3/85, p. 39.

To introduce the distinction between capital gains and ordinary income is to create economic distortion and an opportunity for unjust tax avoidance. The supposed "incentive" objectives of such a preference turn out to be hollow. Not only is a capital gains preference irrelevent to the venture capital market, but with a neutral depreciation system, the elimination of a capital gains preference for real estate, the restriction of interest deductability and the limitation of other tax-shelter devices, a properly reformed tax code will continue to foster investment. This Committee's tax reform legislation must abolish once and for all the capital gains preference.

* * * *

Public Citizen is deeply concerned that the Reagan Plan's combination of a revenue-losing depreciation system and an effective cut in the capital gains rate will amount to a significant net tax cut similar to that created in the Economic Recovery Tax Act of 1981. It is unclear whether or not this tax cut contributed to the recent economic recovery. What is clear is that thanks to these cuts, the IRS was precluded from benefitting from participating in the economy's recent growth. Instead, we are suffering from a staggering budget deficit. No matter how great the speculative benefits of an "incentive"

depreciation system and an expanded capital gains preference may be, they certainly pale in comparison to the vast economic harms brought on by a continued or increased deficit.

D. Oil and Gas

Though the Treasury Proposal rejected expensing of intangible drilling costs on the grounds that it contributed to "divert[ing] capital from other more productive, economic activities," (Treasury Proposal, p. 232) the Reagan Plan substantially restored this tax-break. According to the Plan, the preference is vital to our country's security as it will protect us from over-dependence on foreign energy.

As usual, the Treasury Proposal presented the clearest critique of the Reagan Plan's treatment of these tax preferences and of the Administration's supposed justification for them. In defending the Administration's "goal of increased reliance on free-market forces under[lying] ... [its] energy policy," the Proposal argued that the tax preferences encourage over-production and premature depletion of domestic resources and discouraged conservation and development of alternative domestic energy sources--a combination of factors that heightened, rather than reduced, "vulnerability to foreign supply disruptions."

A recent article in the Washington Post (6/4/85, p. 12) also demonstrates that the Reagan Plan's rejection of the Treasury Proposal is a perfect example of the folly of making industrial policy by means of the tax code. Energy economists

have already rejected the preference as bad national security policy and bad economic policy. They reason that tax-oriented attempts to stimulate domestic production is nonsensical at a time such as now when a world-wide oil glut is depressing prices, since price rather than tax-favored treatment is the biggest factor in determining production output. Moreover, some analysts reason that America should be exploiting current low prices to stockpile foreign oil and increase its strategic reserve. The article, authored by Post Staff Writer Anne Swardson, stated:

> The experience of recent years suggests that exploration is closely tied to prices. Reagan's decision in early 1981 to fully decontrol domestic oil prices helped spark a sizable increase in new drilling. The number of operating land rigs, for example, rose 36 percent from 1980 to 1981.
>
> Worldwide oil prices then began falling in the face of slumping economic activity, and, between 1981 and 1983, the number of operating rigs fell more than 40 percent.

It is hard to believe that an Administration with the analytic clarity to produce the Treasury Proposal could commit such a policy-making blunder six months later. Unfortunately the oil and gas provisions of the Reagan Plan strongly hint at special interest politics. It seems more than a coincidence that with 22 Republicans Senators up for election in 1986 and, as the Wall Street Journal (5/30/85, p. 11) reported, with disgruntled oil tycoons mailing in the "Eagle pins" they received for contributing to the Republican party, their industry should prove to be one of the only ones to enjoy an industry-specific tax break under the Reagan Plan.

In view of reports that in 1984 oil producers in both their individual capacities and through Political Action Committees gave $520,000 in campaign contributions to members of this Committee and its Senate counterpart, it is especially important that this Committee's tax legislation not include tax-subsidies for this industry. Let the Administration's policy errors serve as a warning against special interest policy-making in the tax code.

E. Real Estate Investments and Tax Shelters

It goes without saying that the Committee's own tax legislation should remove each tax shelter device now available in the tax code. Generally speaking, the Treasury Proposal succeeded in doing this to a tremendous extent. The Reagan Plan was successful, but far less so. Its exclusion of depreciated real property from capital gains treatment, its application of the $5,000 limitation on deductible interest for certain real property investments, its repeal of the investment tax credit, its extension of the "at risk" rule to real estate investments and even, possibly, the reduction of the top tax rate would put a serious dent in investors' ability to assemble economically advantageous tax shelters, particularly in the real estate area.

However, the Committee should be wary of the prodigious ingenuity of the tax shelter industry especially since the Reagan Plan preserves a number of tax avoidance techniques that have long been elements of tax shelters, including "incentive"

depreciation rates, the capital gains preference, the oil and gas drilling preference and the pass-through of losses to limited partners regardless of their number. In addition, wealthy investors could probably circumvent the "at risk" rules and the interest deduction limitation. Moreover, agricultural shelters will still be able to exploit the capital gains preference for farm land and rapid depreciation for single purpose farm structures. It is likely that the tax shelter industry, though reduced, would survive under the Reagan Plan. The Committee must ensure that it does not.

F. The Investment Tax Credit

The Committee should follow the lead of the Reagan Plan in repealing the investment tax credit ("ITC"). As long ago as 1978, noted economists Alan Auerbach and Lawrence Summers concluded, in a study of the ITC, that the credit actually had deleterious effects on the economy. The Treasury Proposal concurred:

> The investment tax credit creates an investment incentive that favors some forms of economic activity over others, discriminates among taxpayers within a single industry, and encourages tax-motivated, noneconomic behavior. Because the investment credit is generally limited to investments in tangible personal property, it favors capital-intensive industries over labor-intensive industries. In addition, the ability of taxpayers to benefit from the credit depends on their having taxable income. Thus, start-up, fast-growing, and loss corporations typically derive less benefit from the credit than existing, profitable corporations in the same industries.
>
> The investment tax credit also distorts investor behavior by skewing the relationship between pre-tax

> and after-tax returns on investment. Taxpayers are encouraged to invest in activities eligible for the credit or other preferences rather than activities which, in the absence of tax considerations, might produce a greater economic return. The intrusion of tax into economic life is shown most plainly in the numerous tax shelter offerings which depend upon the investment tax credit and certain other deductions and credits for their viability. To the extent taxpayer energy and resources are consumed in pursuing tax rather than economic advantage, the growth and productivity of the economy as a whole are weakened. Treasury Proposal, p. 173.

In true tax reform legislation, properly based on the principles of economic neutrality and reliance on market forces to maximize productivity and growth, a blatant corporate subsidy like the ITC has no place.

G. The Research and Development Credit

The ineffectuallity of the tax code in setting industrial policy is also exemplified by the Research and Development Credit. According to Robert Eisner, an economist at Northwestern University and a student of the credit, "I would say as an experiment, it's not turning out to be much of a success." Professor Eisner characterized it as a "huge waste of taxpayers' funds." (National Journal, 3/16/85, p. 578.) Economist Edwin Mansfield of the University of Pennsylvania said, "there is little to indicate that the credit boosted business research and development expenditures. In fact, increases in research and development expenditures were greater before the credit was enacted." Id. The economists cited pressure from foreign competitors as the greatest spur to investment in research and development.

Once again, then, the market bests the tax code as allocator of resources. It seems clear that if the business decision-making process were not subject to the warping influences of a tax code that directed investment in fixed, recurring patterns and distorted demand for capital, businesses would be freer to make productive research and development expenditures as demanded by market competition.

At a current cost of about $1 billion per year, the credit has no place in this Committee's tax reform legislation.

H. The Minimum Tax

If anything signals the failure of the Reagan Plan to effect real tax reform it is the inclusion of minimum corporate and personal tax provisions. A minimum tax is necessary--as it is in the Reagan Plan--precisely to the extent that the Plan deviates from the principles of justice and neutrality underlying true tax reform. On page 30 of the Reagan Plan, the Plan presents a chart comparing provisions of current law, the Treasury Proposal and the Reagan Plan. Under "Minimum Tax on individuals and corporations," the chart indicates that such a tax is present in current law and the Reagan Plan but "Not necessary" under the Treasury Proposal. As the Treasury Proposal explains:

> The ambivalence in current law toward tax preferences reflects significant doubt about their fairness, efficiency, costs in lost revenue and consequent effect on marginal tax rates. In general, the Treasury Department proposals accept these doubts as well founded and seek to redesign the income tax base to more closely approximate economic income. If the proposals were fully implemented, the corporate

> minimum tax would be unnecessary.
> Treasury Proposal, p.131

In restoring the minimum tax, the Treasury indicts itself for its departure from true tax reform:

> Since the Administration's tax reform proposals contain incentive provisions that depart from the measurement of economic income, some high-income corporations would be able to eliminate their tax liabilities or substantially reduce their effective tax rates by heavy utilization of such provisions. As under current law, the prospect of high-income corporations paying little or no tax threatens public confidence in the tax system. Consequently, a minimum tax designed to limit the number of high-income, low-tax returns should be retained.
> Reagan Plan, pp. 330 and 334

Moreover, in defining the preferences to be included in the minimum tax calculations, the Plan expressly uses the Treasury Proposal as the standard by which to define and quantify each enumerated preference. To make matters worse, the Reagan Plan's minimum tax is the epitome of an empty gesture. It would raise less than $1 billion a year and, as a result, would fail to remedy the problems of massive corporate burden-shirking that would be inevitable under the Plan.

Tax legislation that included a combination of "incentives" and corporate and individual minimum taxes would not be the equivalent of true tax reform. However, if the Committee cannot produce true tax reform legislation, it will be forced to turn to some sort of minimum tax in order to hold individual tax shelters and corporate tax avoidance in check and to redress at least partially the inevitable failure of rich people and wealthy corporations to bear their just share of the tax burden. In that

case, we would insist that any minimum tax imposed include a rate of no less than 20%, that either defined preferences expansively or applied the minimum rate directly against total income and that yielded appreciable revenues. At the same time, Public Citizen would in such circumstances, also urge the Committee to explore an alternative mechanism such as imposing specified dollar amount caps on each preference or deduction in order to rein in the economically distortive and tax avoidance impact of each investment "incentive" included in the legislation.

For the moment, though, we remain optimistic that the Committee will produce real tax reform and obviate the need for a minimum tax.

I. Credits Not Deductions

The Bradley-Gephardt Fair Tax includes an idea that should be critical to the Committee's efforts to draft tax reform legislation. For a number of preferences in the Fair Tax that benefit individual taxpayers, the Fair Tax uses a 14% credit mechanism rather than a deduction. Preferences under current law, the Treasury Proposal and the Reagan Plan operate by granting taxpayers deductions rather than credits, with the deductions charged against the top-bracket portion of income. As a result, the per-dollar tax savings of a tax-favored expenditure increases with the wealth of the taxpayer. Under the Treasury Proposal, for example, a dollar given to charity or paid in home

mortgage interest by a wealthy taxpayer would, in effect, include a 35 cent tax subsidy. The same dollar given or paid by a lower income taxpayer would receive only a 15 cent tax subsidy. Similarly, the $2,000 personal exemption in the Reagan Plan and the Treasury Proposal is of disproportionate benefit to wealthy families as compared to poorer ones. This is not only regressive, but as a policy it is completely irrational and wasteful.

In drafting its tax reform legislation the Committee should, therefore, adopt a system of tax credits rather than deductions by, for example, charging all deductions and exemptions against the lowest-bracket portion of each taxpayer's income rather than against the top-bracket income, regardless of the taxpayer's total income. This would ensure a vital element of progressivity in tax reform legislation.

J. Elimination of the Presidential Campaign Check-Off

The Reagan Plan's proposal to eliminate the presidential campaign check-off is doubly offensive. First, its inclusion in a so-called tax reform proposal is totally deceptive. Second, it would reverse a significant beneficial reform in the area of campaign financing.

Eliminating the check-off simply has nothing to do with the tax code or tax reform. As a voluntary means for taxpyers to contribute to the financial support of presidential campaigns, the check-off stands as an independent program unconnected to the

raising of government revenue and the sharing of the collective tax burden. Rather, the check-off represents a policy designed to limit the detrimental effects of the need of presidential candidates to raise large sums of money to conduct their campaigns. To the extent that the check-off contributes a significant share to each major candidate's campaign, the system has worked well to protect the political process from the undue influence of special interests, rich individuals and corporations and has given candidates with more limited financial opportunities the chance to participate in the election process. It is interesting to note that though he could have opted out, President Reagan made generous use of those funds in each of his presidential campaigns.

Public Citizen vigorously urges the Committee to preserve the campaign check-off in its tax legislation.

III. The Politics of Tax Reform

A. The Special Interests

Public Citizen is deeply concerned about what many observers agree is the greatest and most obvious threat to tax reform: the tremendous pressure which hoards of special interests will bring to bear on this Committee and on Congress as a whole. The challenge of tax reform is the challenge of standing up to those special interests.

If we did not have faith in this Committee's ability to meet that challenge, we would most likely be here advocating quick

adoption of the Reagan Plan. While we consider the Plan highly inadequate when measured against the standard of real tax refcrm, the Plan does represent a miscellany of modest improvements that move the tax code in the right direction. Closing ranks behind the plan and pushing it through as a package might be the best strategy for overcoming the special interest onslaught.

However, we have confidence that the Committee and Congress will meet the challenge and grasp this historic opportunity to fashion real reform. Unfortunately, the task will be difficult. The flood of Political Action Committee and other special interest money rolling over the members of the Committee creates enormous pressures for each Member, especially given the high cost of campaigning.

According to a study of last year's elections done by Public Citizen, through November 22, 1984, four of the 17 largest PAC contributors in the last elections typify the special interests who will doubtless try to undo tax reform for the sole purpose of protecting and advancing their own narrowly defined interests: National Association of Realtors, National Association of Home Builders, American Bankers Association and the National Association of Life Underwriters. These special interests, like the rest, are the industries and groups of businesses that are happy to sacrifice the integrity of the tax code and the vitality of the economy in order to wrest from Congress some narrowly defined economic advantage for themselves.

The power of these special interests cannot be underestimated. After all, the current code with its glut of counterproductive, economically distorting and wasteful loopholes is a testament to their power. In its study, Aid For Dependent Corporations, Public Citizen demonstrated that special interests were able to build a federal corporate welfare budget of $107 billion a year. Moreover, the special interests are still flush with their victories in recent years in the repeals of withholding on dividends and interest, of stringent automobile record-keeping and of the one-year rule for capital gains.

In November, 1984, the anonymous authors of the Treasury Proposal articulated the principles of tax reform and put them into effect in their Proposal, which was notable for, among other things, its solid intellectual coherence. Six month later, the President introduced his Plan riddled with breaks and advantages for the oil and gas industry, venture capitalists and big business--all in the name of the same "incentives" that the Treasury Proposal had vigorously rejected. President Reagan is banking on the fact that this Committee will not be able to stand up to the special interests any better than he and his Administration could.

We believe, however, that the Committee has no choice but to resist the pressure of special interests. As it is, many analysts are predicting that when the Joint Committee on Taxation and the Congressional Budget Office review the Reagan Plan, they will discover its revenue-losing potential, particularly when the

rate-differential recapture for depreciation lapses and the full revenue-losing force of CCRS takes effect. In the face of a $200 billion deficit, this Committee cannot afford to write a tax bill that would lose revenue. However, the goals of the special interests will not be to add revenue-raising measures to the legislation. Each preference they succeed in adding to the legislation will cost more revenue, leaving the Committee with only a set of non-viable alternatives for compensating for such revenue loss. Certainly, the Committee could not raise taxes on some industries in order to aid others, nor could it extract more taxes from individuals for that purpose by, for example, reducing the standard deduction and personal exemption or raising rates or increasing the tax on fringe benefits.

We are sure that the Administration's plan to restore tax breaks for the oil industry will serve as a chastening example both of the power of special interest lobbies and the need to reject them. As we have discussed above, economists have already discredited the supposed rationale for including the tax breaks. By giving in to the oilmen's "Eagle pin" campaign the Administration sacrificed the ability to claim that its plan represented principled tax reform. Thus, any concessions to special interests by the Committee would represent a double threat to its efforts, since they would bring on renewed tax burdens on individuals and a fatal compromise of the underlying principles of tax reform. For this reason, we are confident that the

Committee will turn its back on the demands of the special interests and push on with real reform.

B. The American People

As Representative Gephardt has said, the key to tax reform will not be the appeasement of special interest opposition, but the rallying of strong public enthusiasm for tax reform. To achieve this the Committee's tax legislation must be scrupulously fair and economically neutral. The authors of the Reagan Plan erred by sacrificing fairness precisely for the purpose of appeasing the special interests. The Plan they produced would not only preserve a system of economic distortion by "incentive" but also would continue the tilt in favor of the rich and big business that makes the current tax system (especially when the Social Security payroll tax is considered as well) essentially a tax on wages and salary.

For all of the President's splendid rhetoric, his Plan does not accomplish much for the average taxpayer. Families earning between $20,000 and $50,000 per year would get, on the average, a $150 per year tax cut--less than $3 a week--while families earning $200,000 or more would enjoy a $9,400 yearly cut. At the same time, taxpayers would, for the first time, pay taxes on a portion of their fringe benefits and would lose the ability to deduct state and local taxes. From the point of view of pure, principled tax reform, these latter changes in the law may be defensible. The Reagan Plan, however, would not deliver pure, principled tax

reform, and the President has all but confessed that these proposed new taxes, particularly those created by the elimination of state and local tax deductibility, are meant to advance the Administration's own irresponsible anti-government policies.

The Reagan Plan's only other justification for inclusion of these new sources of taxation is revenue-raising. The gross inequity of the argument is obvious, however, given that the Reagan Plan rejected the single biggest revenue-raiser in the Treasury Proposal when it scrapped the Proposal's depreciation scheme, which would have yielded $213 billion in new revenues in the first five years. In short, for less than $3 per week, taxpayers would continue to suffer under a system with a lucrative capital gains preference for wealthy investors and would continue to finance a huge depreciation subsidy for big business.

In addition not only would taxpayers be taxed on fringe benefits for the first time, but by the Reagan Proposal's method of taxing the first dollars of fringe benefits rather than the last, those with more generous benefits packages would have the greatest advantage. Even the increase in the personal exemption, a clear benefit to the average taxpayer, would benefit wealthy people with large families even more. The same is true for the proposed conversion of the child care credit into a deduction. The Reagan Plan's $3 per week average savings on income tax would have even less of an impact for taxpayers than might otherwise appear, since taxpayers would continue to bear a substantial Social Security tax, which itself includes the highly

regressive feature of excluding income over $40,000. Added to this is the continued erosion of progressivity in the structure of the income tax that the Reagan Plan would induce, as taxpayers would pay no more than 35% no matter how high the income.

Regardless of the size of their own tax savings, taxpayers, whose primary concern is fairness, would not accept as tax reform, legislation that contained this amalgam of regressive provisions. At the same time, in the name of revenue neutrality this pale imitation of tax reform would not even provide Americans with relief from the current federal budget deficit. In view of the Reagan Plan's commitment to massive depreciation subsidies, moreover, the result of its enactment may well be even greater deficits. For $3 a week it is inconceivable that Americans, whose concern for tax fairness is exceeded only by their fear of the deficit would tolerate so-called tax reform that offered nothing better than a shaky, unsubstantiated promise not to add to the deficit while offering no hope of reducing it.

CONCLUSION

In the course of his campaign for tax reform, the President may or may not succeed in convincing the public that his Plan is true tax reform. What his rhetoric will certainly do though, is create high expectations among the American people for tax legislation that produces a just and progressive distribution of the tax burden and an "incentive"-proof economic neutrality. His Plan, however, simply fails to meet those expectations. Consequently, it is up to this Committee to produce genuine tax reform legislation that is shaped by these principles.

STATEMENT OF PETER L. BAUMBUSCH, TREASURER, FAIR TAX FOUNDATION, WASHINGTON, DC, ACCOMPANIED BY LIVIA BARDIN, EXECUTIVE DIRECTOR OF THE FAIR TAX FOUNDATION

Mr. BAUMBUSCH. Thank you very much for the opportunity to be here today. With me is Livia Bardin, the Executive Director of the Fair Tax Foundation. I am a member of the Board of Directors of the Foundation.

We were founded in August of 1982, and our objective is to inform citizens of this country about ways to apportion the tax burden fairly and also to improve the Nation's economic health.

In this regard, we have looked at a number of proposals, and we support the Bradley-Gephart proposal. We find that there is a broad base of support for tax reform in our country. We have noted that one brief television appearance in which the suggestion was made for people to send in letters if they were interested, yielded 15,000 letters. We have started a petition campaign as a result of that. We alreday have 45,000 signatures in a short time and intend to present those petitions when we have completed our task.

We believe, from the letters that we have received from people who are interested, that there is an understanding, although imperfect, of the idea that some 'benefits' are going to have to go in order for rates to be reduced. We think the President's proposal is a good start, and we are happy with the idea that tax reform is finally a major issue. However, we believe there is a better way.

I compared two books that I happen to have. One is the President's book of 461 pages, and there is another book which I have recently read called 'The Fair Tax' by Senator Bradley. And it is 190 pages. I think it is simpler and better. In fact, I will offer a copy of this book to all members of the Senate Finance Committee; I am sure they will enjoy it.

Senator BRADLEY. I've already gotten one.

The Chairman. I was going to say, I don't know if it was from Senator Bradley or not, but I can assure you that I think we have all gotten one. [Laughter.]

Mr. BAUMBUSCH. In any event, we do have some concern about the President's proposals, because we are concerned that the stage might be set for giving way to every special interest. We notice that the incentives in the President's plan retain the incentives to all special interests to fight to retain their present privileges. The writing off of assets faster than true depreciation will encourage others not to write off their changes for a special tax break. Loopholes in the name of national security will open the loops for dozens of special interests under the national security umbrella.

The letters from our supporters show great concern to ensure that the special interests will not get oiled while the average taxpayer gets gassed.

We are particularly concerned with the way this committee approaches issues of tax reform. When any group comes forward to this committee and says, 'We would like to retain this benefit or that benefit because it's necessary for our industry,' I think the question should be asked, 'Why won't the market sustain your industry?' What is wrong with the economic system in our country

that it cannot allocate resources without special guidance from the government?

I think the tax incentives, in terms of specialized depreciation treatment, or oil and gas incentives that exist in the President's program have to be seriously questioned, because they imply that the market does not work.

They will of course give answers. They will say, 'Well, there are jobs, and there is national security.' But the jobs may no longer be in the blacksmithing trade, you know, they may be in chip manufacturing and they may be in health care.

Also, we have noted concern about state and local tax deductions, and the fact that they will go. And I should point out to you that under the Bradley-Gephart proposal, charitable contributions, state and local tax deductions are still available—in a modified fashion, yes, but available to the large majority of taxpayers. And therefore, I think that is one of the ways to compromise that issue.

I note, Senator, that you have evidenced a lot of concern about fringe benefits. I would just say to you that that becomes somewhat of an issue of fairness and philosophy. And I agree with many of the philosophical questions you have asked. However, I think that it has to be recognized that, if we allow certain large exemptions in that area, there is always pressure to skew the system unfairly against those who do not have the benefit of those fringe benefits.

We think, in general, the base should be broadened as much as possible so that the rates can get down to the 30 percent top rate of Bradley-Gephart, which we believe is going to yield an economic boom in our country.

[Mr. Baumbusch's written testimony follows:]

TESTIMONY OF

Peter L. Baumbusch

Before the Committee on Finance

June 19, 1985

Summary

The Fair Tax Foundation is a non-profit organization whose purpose is to promote fairness, simplicity and efficiency in the United States tax system. Its work is primarily done by volunteers. The Foundation supports the Bradley-Gephardt bill.

We have received thousands of letters from people who want tax reform. We are convinced that the country feels strongly about tax reform.

We think the President's plan is an excellent start but we are concerned about perilous concessions to the special interests that may jeopardize the entire undertaking.

We believe that Bradley-Gephardt provides better solutions to the problems of tax reform and we urge you to consider them.

TESTIMONY OF

Peter L. Baumbusch

Before the Committee on Finance

U.S. Senate

June 19, 1985

My name is Peter Baumbusch. I am here today on behalf of the Fair Tax Foundation, a non-profit organization whose purpose is to promote fairness, simplicity and efficiency in the United States tax system.

The Fair Tax Foundation was formed on August 5, 1982, pursuant to the provisions of the District of Columbia Non-Profit Corporation law as a tax-exempt organization under Section 501(c)(4) of the Internal Revenue Code. I am the Treasurer and a Director of the Foundation. The work of the Foundation is primarily carried on by volunteers.

The objective of the Foundation is to inform United States citizens about ways of taxation that apportion the tax burden fairly and improve our country's economic health and to encourage grassroots support for tax reform. Specifically, we support the Bradley-Gephardt bill.

People Want Tax Reform

There is no doubt the country feels very strongly about tax reform. When Senator Bradley appeared on the Donohue show in spring, 1984-- before all the publicity surrounding the current proposal-- more than 14,000 listeners responded with pleas for fairer, simpler tax laws that treat taxpayers more equitably. The

petition drive we launched then has already produced nearly 45,000 supporters.

We have also received thousands of letters. I quote from a few of them:

"I support and encourage your efforts to revolutionize our tax system....Everyone is sick of the present tax plan."

"I fully support drastic changes in tax laws. I am prepared to lose benefits of Social Security and interest on mortgages and real estate taxes if the overall improvements can be achieved."

"My husband just got a raise of $100 per month and his paycheck is $3 less than before the raise--all going to taxes...."

(from an accountant) "I am strongly in favor of major tax simplifcation.....I would much rather spend the majority of my time providing management consulting services to my clients, than spending their money on tax compliance."

"I am a Revenue Officer for the Internal Revenue Service....I see every day that the system is wrong and unfair.....make some changes for the people, not for the few who can lobby for what they want!"

President's Plan a Good Start

We are heartened by the serious approach to tax reform embodied in the President's plan. We think it is an excellent start and we are flattered by its many similarities to Bradley-Gephardt. By the same token, we are concerned. The President has made some perilous concessions to the special interests that could jeopardize the entire undertaking.

The cost of these concessions in revenue foregone results in a

higher top rate under the Reagan plan than in Bradley-Gephardt, (35% as opposed to 30%).

The minimum tax provision also signals trouble. A minimum tax is only necessary if the tax code leaves too much room for certain businesses to escape taxation altogether.

Most importantly, the loopholes--or, if you will--incentives that the President's plan retains are in themselves an incentive to all special interests to fight to retain their present privileges. Writing off assets faster than true depreciation will encourage others not to write off their chances for special tax breaks. Loopholes in the name of national security will open the loop for dozens of enterprises under the national security umbrella.

Bradley-Gephardt is Better

While we commend the President's effort, we urge the Congress to consider most carefully the problems presented by the proposal. We think Bradley-Gephardt, the Fair Tax, provides the solutions.

Thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Previously we had some discussion on not granting the double exemption for the senior citizens. I would be interested in your thoughts on that, Mr. Davidson.

Mr. DAVIDSON. Well, I think the President's plan, by reducing the tax on lower-income people, [and that would also be the case even with our proposed shift over to a tax credit], would take care of most of the tax problems the senior citizens have in this country.

We have a lot of programs on the books that help senior citizens. They use most of the health care services funded by government. They get a big benefit there. There are very substantial benefits to senior citizens in other ways, and I think they are not any longer as deprived as they were in the years past before some of these programs were put in place.

The top fifth of our country in terms of age are also the wealthiest in our country. And I think that, while there are many people in that group who are poor, there are also many who don't need special attention, and I think the President's plan in that respect strikes a good balance.

Senator CHAFEE. Mr. Goffman, on the capital gains. As you well know, there is no capital gains treatment in Treasury-1, and the change was made in Treasury-2, the Administration's plan. I think that followed as a result of the advice and concerns that many of us had in talking with Secretary Baker before he came forward with Treasury-2. It seems to us that this truly is a capital-creator, the special treatment of capital gains; people are putting their

money at a risk. I am not quite sure I understand your arguments that the differential should be eliminated.

Mr. GOFFMAN. Well, our understanding of the impetus on capital gains preferences put back into the President's plan was that it came largely from——

Senator CHAFEE. Well, never mind where it came from; it is here. Excuse me. Go ahead.

Mr. GOFFMAN. Our feeling is that, in terms of capital creation or encouraging investment, a system of indexing capital assets and then treating them as ordinary income probably is skewed more in favor of people who make long-term investments—both personal individuals and investors. Our concern is that the cost of retaining a capital-gains preference involves a lot of distorted—not productive but distorted—economic decisionmaking, and it leaves a tool that tax shelter builders or exploiters can use. So, the negative impacts of those distortions probably outweigh whatever positive impact there is.

Again, the question is, why are we abandoning this faith in the marketplace, why do we feel that we have to build in this kind of incentive for investments, when after all what the market promises is a reward for those investments?

Senator CHAFEE. Do you mean you think, with the lower rates, you are rewarding the speculator, the investor? Let's use the kinder word, investor, rather than speculator.

Mr. GOFFMAN. It is not just the lower rates; more importantly, it is the marketplace itself that rewards those kinds of investments. And I just can't see how we can make a case that there is something wrong with the marketplace, that we need the Tax Code to support it.

Senator CHAFEE. Well, Mr. Baumbusch touched on fringe benefits. Now, if you are taxing people on their incomes, what is coming in, why should fringe benefits remain untaxed?

Mr. BAUMBUSCH. Because that is income coming in.

Senator CHAFEE. You suggest they should be taxed?

Mr. BAUMBUSCH. Yes.

Senator CHAFEE. But, Mr. Goffman, what would your view be?

Mr. GOFFMAN. My view is that not taxing them creates significant unfairness to those who do not have employer provided fringe benefits. However, I think I am going to accept the distinction that the Chairman suggested before, that there is a difference between social policymaking and business or economic policymaking, and that there are times, if you satisfy the very high threshhold of persuation, notwithstanding the unfairness of not taxing certain compensation, notwithstanding the difficulty of targeting those incentives, when social policy would suggest that the Tax Code be used to foster certain kinds of social behavior.

Senator CHAFEE. Well, I don't argue with that. I think we have heard many discussions in this committee on that subject. I think the view the Chairman so frequently espouses that it is cheaper to have the employer provide adequte health insurance than the Federal Government because it is more efficient is one I will not argue with. I think there is a lot of merit to that.

But I really have tremendous difficulty understanding this taxing of the first part of the fringe benefits, the first $300, and let-

ting the balance go untouched. Can you give me any justification for that?

Mr. GOFFMAN. I can give you a justification for it, but I am not sure it is going to be a persuasive one.

Senator CHAFEE. Well, nothing has been persuasive so far, so why don't you try? [Laughter.]

Mr. GOFFMAN. From a consumer point of view I think the argument is that the last dollars into a benefit plan are often the most efficient dollars, because they go to prevention and health care maintenance rather than to after-the-fact treatment of illness or trauma.

However, I think from the point of view of fairness the Treasury-1 plan probably got it right, because the impact on lower and middle income taxpayers is greater if you tax first dollars in and then allow the rest to escape taxation.

So I think our position would be to follow the lead of the first Treasury plan.

Senator CHAFEE. Mr. Baumbusch.

Mr. BAUMBUSCH. I am concerned that we do keep our eye on the ball, and the ball here is the broadening of the base as much as we can and the reduction of rates.

With respect to the issue of fringe benefits in particular, obviously there are social policies involved. However, I think there are other problems with the current system. We have noticed, for example, that health care costs have been increasing at a much, much higher rate than the rate of inflation. And part of the reason for that is, because they are not given the true economic costs in our society, people don't make choices the way they would make if they knew the true economic costs. And therefore, the price goes beyond where it ought to be.

I don't think there is any perfect solution to the problem, but I am more inclined to agree with the ideas in Treasury-1, to say that above a certain level we are going to have to cut this off.

Now, the suggestion that somehow this will mean we don't have health benefits for people, I think, is also wrong. The policy has been widely established in our country. It is certainly something that is bargained for in most labor negotiations. Just as people bargain for wages, there is no reason to think they won't bargain for health benefits. Just because wages are taxable today, people don't say, 'Well, we are not going to bargain for them because they are taxable.'

If a measure of health care benefits are taxable, I believe we will still have an effective system in our society; but, we will have a measure of fairness, so that one person living in one house doesn't get taxed differently than a person living next door, by virtue of the fact that one has health care benefits.

Senator CHAFEE. Thank you, Mr. Chairman.

The Chairman. Senator Bradley.

Senator BRADLEY. Mr. Chairman, if I could, I'll just follow on with Senator Chafee.

Senator CHAFEE. I have to leave, unfortunately.

Senator BRADLEY. I will follow on with him in private. [Laughter.]

Senator CHAFEE. Well, I am interested. I can stay one moment.

Senator BRADLEY. As the Chairman sees it, there appears to be a Hobson's Choice on the question of health care benefits. I know the Chairman feels very strongly about this issue and says that we either have it the way it is now, with tax subsidies, or we have to have a national health insurance program like they have in Britain. I really think there is a third option. The third option is that the company continues to offer group health insurance and the worker continues to want coverage, and they are able to pay for it because a majority of working men and women will pay less tax after rates are lowered.

If you assume someone is making $20,000, and their employer contributes $2,000 to a health policy, under a truly broad based tax reform proposal, this adjusted gross income will be $22,000. But they will be taxed at a much lower rate. And in many cases they end up not only with the same health insurance coverage that they always had but with a lower tax burden to boot.

My only point is that we have to keep in mind that there is a third possibility. The choice is not just between an exclusion for employer provided insurance and a massive, costly national health scheme.

So I am sure we will revisit this often. I don't want to detain you any more.

But let me thank the panel for their testimony, particularly Mr. Baumbusch for pointing out this great literary work. [Laughter.]

Let me call attention to what Mr. Davidson said today about the exemption. You suggested it be a credit. That is surprising, because that is essentially the same thing that the Fed Tax does. The aim of it is that it should be worth more to people at the lower level of the income scale than at the upper end. And that is virtually the same thing Martin Feldstein said yesterday in recommending that the exemption be limited to the lowest rate. So it is interesting to see that theme echoed again from a different perspective.

Let me just ask each of you briefly, as I will most of the panels, if you can agree that tax reform should do certain things. And I would like Yes or No answers.

Do you agree that tax reform should not increase the deficit?

Mr. BAUMBUSCH. Yes.

Mr. GOFFMAN. Yes.

Mr. DAVIDSON. Yes.

Senator BRADLEY. Do you agree that tax reform should not increase the relative tax burden on middle or low income people?

Mr. BAUMBUSCH. Yes, very much so.

Mr. GOFFMAN. Yes. Absolutely, Senator.

Mr. DAVIDSON. I think that is a complicated question. I think in general we should not try to increase the tax burden on anybody. I think, however, that there is a problem that comes out in the Treasury plan which we need to address, and that is that it aims, by way of increasing fairness, to increase substantially the tax on capital. And I think what we need to do is move more to a tax on consumption. In that respect it may be that we would have to shift the burden slightly, in the short run, because our trading partners have much greater incentives for capital investment than we do.

Senator BRADLEY. OK.

Do you believe that we should have the lowest rates for the greatest number of people?

Mr. BAUMBUSCH. Yes, across the board.

Mr. GOFFMAN. Yes.

Mr. DAVIDSON. Absolutely.

Senator BRADLEY. Do you believe that tax reform should be as neutral as possible in the allocation of capital? Not favoring certain kinds of assets and investments over other kinds of assets and investments?

Mr. BAUMBUSCH. Yes, I think that is what is going to yield productivity increases.

Mr. GOFFMAN. Again, absolutely.

Mr. DAVIDSON. Yes.

Senator BRADLEY. Thank you very much.

Mr. GOFFMAN. We would actually favor increasing the burden on the highest income earners.

Mr. DAVIDSON. If I could elaborate on what I said before in the original answer, Senator Bradley, I don't think we should base our decision about tax reform on a static analysis, tring to preserve whatever the existing incidence of taxation happens to be.

I think what we ought to do is what I said in my testimony, which is to try, insofar as we have the wisdom, to achieve a tax system for the United States that raises the most revenue with the least harm to the society. There are lots of costs from having inefficient tax systems that do not show up in the incidence of taxation as we calculate them, in terms of who pays what burden.

If a fellow doesn't have a job because the tax on capital has been raised so much that he has been put at a disadvantage against the Canadian company where his job has migrated, or some other country's company, then the incidence of that tax in a certain sense is much higher than it would be if you just looked at static analysis.

So I would say, let's try to get the system that will produce the most efficiency and yield the most revenue. And then if we are upset with the distributional effects, address these later on in some other way.

The CHAIRMAN. Well, the intriguing thing about the way Senator Bradley asked his question—and I think he has asked it of almost every witness that has been here——

Senator BRADLEY. And I will.

The CHAIRMAN. And he will. And to the extent that a witness answers, "No, I don't want to change the relative incidence of taxation," the witness is saying, "I am satisfied with the present incidence of taxation, and the wealthy are paying enough." Now, Mr. Goffman very clearly says, "No, I don't agree with that premise. I think the wealthy ought to pay more." Is that a fair statement?

Senator BRADLEY. If the Senate overwhelms me on that issue and demands that the wealthy pay more, that's the way it goes.

The CHAIRMAN. Every now and then you get rolled. [Laughter.]

I have no other questions.

Thank you very much for coming.

[Whereupon, at 10:55 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF FRED WERTHEIMER

PRESIDENT OF COMMON CAUSE

on

PRESIDENT REAGAN'S TAX REFORM PROPOSAL

submitted to the

SENATE FINANCE COMMITTEE

June 19, 1985

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to submit this statement on behalf of Common Cause about President Reagan's proposed tax reform.

Common Cause supports comprehensive reform of the tax system. Our National Governing Board endorsed a fundamental overhaul of the nation's tax system in 1982, and in 1983 we endorsed the general approach to tax reform set forth in the Fair Tax Plan developed by Senator Bradley and Representative Gephardt. Earlier this year we also endorsed the comprehensive tax reform approach developed by the Treasury Department, the so-called Treasury I proposal, which was based on many of the same principles as the Bradley-Gephardt plan.

It has always been clear that without presidential leadership, comprehensive tax reform is impossible to achieve. We very much welcome the strong commitment that the President has made to comprehensive tax reform and to the basic overall approach that is needed to create a fairer, simpler and more efficient tax system.

While we welcome President Reagan's commitment to tax reform, I want to make clear that we do not share some of the views he has been expressing to advance this goal.

The President, for example, recently associated himself with the view that cheating on taxes today "isn't a sin, it's a duty." That kind of rhetoric from the leader of our

government not only undermines compliance with the tax laws, but it also undermines the effort to achieve tax reform.

The President has described his tax campaign as another effort "to get government off our backs." Justice Oliver Wendell Holmes, Jr. once said, "Taxes are the price we pay for a civilized society." We would associate ourselves with Justice Holmes' view.

The challenge we face is not to reduce taxes and, thereby, reduce the many vital services that government provides. Rather, the challenge is to collect the necessary taxes as fairly and efficiently and with as little adverse impact on the economy as possible.

The Finance Committee is now faced with one of the greatest challenges and responsibilities ever to confront the Congress. No government program affects more facets of our national life or reflects more of our national values than the tax code. The expertise of this Committee and the job it does in developing a legislative proposal will go a long way towards determining whether a new, fairer tax system is created or whether a once-in-a-lifetime opportunity is passed up.

The President and his Administration have had their turn. Now the responsibility is yours.

* * *

We, like many others, are still reviewing the plan proposed by the President. I would like, however, to summarize our general reaction to the plan and indicate our

views concerning some of its most positive features and some of the areas which cause us serious concern.

Our overall view is that the President's plan contains a number of the major ingredients that are essential to comprehensive tax reform, but that it also has critical flaws that undermine its fairness and reduce the prospects for obtaining public acceptance.

On the positive side, the President's plan carries forward many important features of the earlier Treasury I reform plan. These include cutting overall tax rates, abolishing many of the tax preferences in the present tax code, reducing the excessive tax burden on low-income taxpayers, increasing the corporate share of taxes paid, and eliminating or restricting often-abused business deductions for meals and entertainment. On the other hand, the President's plan also retreats from fairness in critical areas and raises serious questions about its revenue implications. These problems not only undermine the plan's appeal as it currently stands but also open the door for further serious erosion in Congress.

Revenue Implications

We cannot afford to create a new tax system that reduces the federal government's revenue base, either on a short-term or long-term basis. This needs to be a threshold consideration and goal for the Committee and the Congress.

The huge tax cuts of 1981 have already substantially reduced the government's revenue base and played a major role in creating the enormous federal deficits we face. Any further erosion of the government's tax revenue would not be responsible and must be avoided.

The President has incorporated the goal of avoiding revenue reductions into his proposal, stating that it is designed to be "revenue neutral", that is, neither to raise nor lower revenues compared with the present tax system.

Obviously, estimating future revenues with precision is extremely difficult. We strongly urge the Committee, therefore, to err on the side of protecting against any revenue losses occurring in the plan that it ultimately recommends to the Senate.

Our concerns in this area have been heightened by some of the features in the President's plan. The depreciation recovery provision and the postponement of the proposed rate reductions until July 1, 1986 (six months after the plan would eliminate many tax preferences) seem to be last-minute improvisations designed to justify a claim of revenue neutrality. Even assuming these features are warranted on their merits, they will provide only a short-term boost to revenues, and it is not clear how revenue neutrality will be maintained after their effect is exhausted.

We also would note that the Administration says that, in the long run, the President's plan will provide a 7% tax cut for individuals and a 9% increase for corporations.

Since corporations currently pay less than one-fifth of the government's income tax revenues, it is not clear how revenue neutrality can be consistent with this claim.

In the past, tax reforms have been enacted with the "sweetener" of a tax cut, which helped to ensure that the reform plan would produce more winners than losers. Obviously, we are not in a position to use that strategy in the nation's current fiscal circumstances. Our nation simply cannot afford to have tax reform become a tax cut.

Retreat from Fairness

The President's plan has retreated in a number of critical areas from fairer approaches set forth in the Treasury I and Bradley-Gephardt proposals. In so doing, the Administration has responded to the voices of some very powerful interest groups in our society.

The net result of these changes is to undermine the principles on which Treasury I and Bradley-Gephardt were based and to set the stage for other groups to be able to make changes to protect their tax preferences.

As Senator John Chafee warned prior to the President's plan being unveiled, "The more tax preferences that are in the proposal from the President, the harder it is to keep the others out. . . . If the President keeps the tax incentives for oil and natural gas, then, of course, it makes it harder to justify eliminating the tax credits for alternative energy proposals such as solar."

President Reagan has correctly warned the public in recent days about the enormous pressures that special interest groups and lobbyists will bring to bear to protect their tax advantages. But the President's plan sends out a different message.

Since the plan already reflects the success that some powerful interest groups have had in lobbying the Reagan Administration, the message it sends to special interest lobbyists is, "If you push hard enough and have enough clout, you too can keep your tax breaks." This can only serve to seriously jeopardize the chances of comprehensive tax reform.

This Committee will no doubt hear various meritorious arguments from various interests in support of maintaining their tax preferences. Given the nature of comprehensive tax reform, however, these are not matters that can be considered solely on an ad hoc basis. The question for the Committee in each instance is going to be whether the case for making an exception is so clear and powerful that it can justify special treatment for that interest, and whether such special treatment can really be given without jeopardizing the ability to ultimately create a new tax system for the country.

Among the special preferences in the President's plan that concern us are the following:

Oil and gas taxation: The President's plan would leave intact much of the tax preferences for the oil and gas

industry that would have been repealed by the original Treasury proposal. According to estimates, Treasury I would have raised more than $30 billion in additional taxes on oil and gas during the period 1986-1990 while the President's plan will result in an increase of less than $5 billion.

The original Treasury plan, in proposing to repeal the expensing of intangible drilling costs ("IDC"), noted:

> Based on the 1980 minimum tax data, it is estimated that in 1986, 31,000 individuals with adjusted gross incomes over $100,000 would receive over one-half of the total IDC tax benefits that go to individual taxpayers. These 31,000 taxpayers thus receive an average benefit of approximately $28,000.
>
> Termination of these tax subsidies would increase the fairness of the tax system and permit reduction of the tax rates for high income and other individuals.

Under the President's plan, however, while the tax rates for high income individuals are reduced, the IDC tax benefits still remain. The oil and gas industry has always exercised special clout and received special treatment in our political system.

The Administration justifies changing its approach on oil and gas taxation on the basis of "national security considerations." Does it make sense, however, to encourage more domestic production through the tax code at a time of an oil glut? Are tax preferences, many of which apply to tapping existing oil fields, the most efficient way to increase our energy independence? And, most important, does the oil and gas industry really have such a powerful case for special treatment that it is entitled to keep these tax advantages while so many other interests are losing theirs?

We do not think so. As Senator Chafee pointed out, continuing the tax preference for oil and gas will make it that much harder to defend ending other preferences.

Capital Gains Preference: Both the Treasury I and Bradley-Gephardt proposals combined the lowering of top tax rates for individuals with eliminating the special tax treatment for capital gains. Bradley-Gephardt treats capital gains as ordinary income while Treasury I treats them as ordinary income after adjusting for inflation.

The President's plan, on the other hand, not only maintains but actually increases the special tax benefits for capital gains while lowering the top individual rates.

This combination of increased capital gains benefits and lower individual tax rates appears to be the principal reason why the wealthiest people in America end up with some of the greatest tax relief under the President's plan -- with cuts averaging 10% for those with incomes above $200,000. It is very hard to square this result with the notion that the President's plan is a new tax system for Main Street, America, a tax system that is fairer for all Americans.

The capital gains tax preference mainly benefits high-income taxpayers. IRS data indicate that nearly 70% of the capital gains from sales of corporate stock, for example, go to less than 5% of all taxpayers --- those with incomes over $100,000. We urge that the Committee return to the basic approach to capital gains taken by the Treasury I

and Bradley-Gephardt proposals by combining reduced individual tax rates with elimination of the special preference for capital gains.

Fringe Benefits: The President's plan would maintain the current tax-exempt status of employee-paid life insurance and many other fringe benefits, and it would tax only the first $10 per month of employer contributions to an employee's health plan for individual coverage or $25 per month for family coverage. In contrast, Treasury I would have ended the tax-favored status of most fringe benefits, and it would have taxed only the most generous employer-paid health plans -- that part of the employer contribution in excess of $70 per month for individual coverage or $175 per month for family coverage.

We think the Treasury I approach to fringe benefits is much fairer than the President's plan. It would reduce the present bias in the tax laws against individuals who have few or no fringe benefits and instead tax more heavily those individuals with the most generous health plans. It would also provide greater incentives to control the inflation that is driving up medical care costs.

Key Features of the President's Plan

As noted earlier, we believe the President's plan contains many important features, a number of which provide for substantial improvements over our present tax system. These include:

Base-broadening and rate reduction: The basic approach in the President's plan -- reducing tax rates and broadening the tax base by eliminating or reducing tax preferences -- is the same as the approach developed in 1982 by Senator Bradley and Representative Gephardt in their Fair Tax Plan. We believe it offers the most practical and constructive approach to a new, fairer tax system. The combination of lower rates and a broader base can help reduce the tax system's complexity, lessen the variation in tax liabilities among taxpayers with similar economic incomes, reduce the disincentives to work and saving, and encourage a more efficient allocation of resources among industries.

Progressive rate structure: While the President's plan maintains roughly the same distribution of tax liabilities by income class as the present tax system, it does make significant changes in the relative tax burdens of our poorest and wealthiest citizens. We regret the failure to restore the progressivity that has been eroded from the tax code by the effects of inflation and tax changes made over the past decade.

We applaud the President's plan for providing substantial relief for low-income families and individuals. According to the Administration's estimates, the President's plan would reduce the federal income taxes of families with incomes of less than $10,000 by almost 36% and of those with incomes between $10,000 and $15,000 by about 23%. Moreover,

virtually all families and older, blind and disabled individuals with incomes at or below the federal poverty line would be freed from income taxation altogether. We believe this relief for low-income taxpayers is fully warranted and ideally would be even greater. It is important to recognize that the poor have benefited the least from the tax cuts enacted in recent years. In fact, wage-earners at the poverty level now pay much higher federal taxes than they did a decade ago. Moreover, even with reduced income taxes, the poor will still bear a heavy tax burden in the form of payroll and other taxes.

The tilt of the President's plan in favor of the wealthiest individuals in the country, on the other hand, is one of its greatest flaws. By giving large reductions -- over 10% -- to individuals with incomes of $200,000 or more, the plan further reduces progressivity and treats those individuals substantially better than it does the average taxpayer. As suggested earlier, much of this reduction results from the President's decision to reduce capital gains rates to 17.5% while also reducing individual tax rates. We do not see any public policy rationale for giving such large reductions to the wealthiest taxpayers in the nation; if anything, the effective tax rate on this group of taxpayers should be increased. Ending the capital gains preference would be an excellent place to start.

Greater corporate tax burden: The President's plan shifts some of the present tax burden from individual

taxpayers onto corporations. We think this shift is long overdue. As recently as 1966, the corporate income tax provided over 23% of total federal revenues, but it has declined greatly since then and amounted to less than 10% of total revenues in 1983 and 1984.

The President's plan would be an important first step toward restoring the corporate tax burden. It would raise corporate tax receipts by an estimated $118 billion over the five year period 1986-90, an increase of about 24% over the current system. It is not clear, however, what effect the President's plan would have in later years, since a substantial portion of the increased revenue ($57 billion) would be raised by the plan's depreciation recapture provision, which would expire after three years. The effort to restore an effective corporate tax should not be limited to short-term measures.

Restrictions on business entertainment deductions: The President's plan would abolish all deductions for business entertainment other than meals, and it would limit the deductibility of business meals to $25 per person plus 50% of the amount over $25. While the restriction on meals may be overly generous, the provision as a whole is a significant step toward limiting a much-abused feature of the tax code. We can fully understand the outrage felt by the average taxpayer who pays for his or her own meals and entertainment and discovers that the tax system is subsidizing other individuals who claim a business purpose

to eat at expensive restaurants or get the best seats at sporting events or the theatre.

* * *

There are two other areas that I would like to discuss in this statement. The first has to do with strengthening congressional scrutiny of tax expenditures. The challenge Congress faces is not only to pass a comprehensive tax reform bill, but also to ensure that the tax system created by that bill is not quickly eroded away with new tax breaks.

Review of Tax Expenditures

Common Cause has previously issued two studies of tax expenditures, and we expect to release a third such study shortly. These studies show that the Congress has never scrutinized tax expenditures on an orderly or effective basis. One result of this has been that tax expenditures have continued to grow dramatically in recent years, increasing from $228 billion in 1981 to some $330 billion in 1984. Most dramatically, this growth has taken place even though drastic cutbacks have been made over the same period in many direct spending programs.

If tax reform is to succeed, Congress will have to be much tougher in the future in scrutinizing appeals to create new tax preferences and in reviewing the ones that have been created. Among the steps we urge you to consider toward that end are:

-Establishing a pay-as-you-go requirement in the future for tax expenditures that would require anyone proposing a new or expanded tax expenditure to propose a way to make up for the revenue that would otherwise be lost;

-Putting expiration dates on tax expenditures and requiring that they be rigorously reviewed at periodic intervals; and

-Developing ways to strengthen the coordination of tax expenditures with direct spending programs that are designed to serve the same general policy aims.

Dollar Tax Check-off

The last issue that we want to address has nothing to do with tax reform but, since it was included in the President's plan, it does require attention. That issue is the President's proposed elimination of the dollar tax check-off for presidential election campaigns.

Repeal of the dollar tax check-off is not tax reform and does not fit within the general approach of tax reform announced by the Administration. As the Administration itself has conceded, "the check-off does not directly affect individual tax liabilities." The tax check-off is not a tax preference. It is not a device for lowering any individual's taxes. Rather, the check-off is the funding mechanism for directing to a particular program -- the public financing of presidential elections -- taxes which are already owed to the government.

The Administration claims it favors elimination of the check-off because it "is a source of confusion" to taxpayers. Yet the Administration does not propose an alternative source of financing for the program in its tax reform plan, and a White House spokesman has indicated that the President would probably oppose any congressional appropriation for the fund.

The net result of the Administration's proposal would be to kill presidential public financing, not by repealing the program but by eliminating the mechanism that is used to fund it. As The New York Times said in a recent editorial defending the check-off, the Administration's proposed abolition of the check-off is a "sneak attack on campaign finance." The Times went on to conclude, "A tax package is the wrong place, and stealth is the wrong way to revise campaign and election law."

The Washington Post, in a recent editorial also supported the tax check-off, saying, "The official answer is that the checkoff was eliminated in the Reagan plan because it takes a line on the tax return and has confused some taxpayers; you see, they say, we just wanted to simplify things. Sure. Intentionally or not, the scrapping of the checkoff makes a major change for the worse in a campaign finance law that has worked tolerably well. This isn't a tax issue at all. Whatever Congress does with the president's bill, it should keep the checkoff as it is."

Since the public financing system was created in 1974, 34 of the 35 major party presidential candidates have taken advantage of the check-off's funds. President Reagan himself, who apparently has never designated a dollar of his own taxes for the fund, has received over $90 million in public funds for his 1976, 1980 and 1984 presidential campaigns.

Under the public financing system, campaign spending has been limited, and candidate reliance on pre-Watergate "fat cats" and special interest groups for their political funds has been replaced by a new source of campaign funds -- public dollars designated to a separate account by individual taxpayers. As the New York Times editorial noted, "Public financing confers on Presidential candidates the freedom not to grovel."

The presidential public financing system has worked well. Repeal of the dollar tax check-off serves as a back-door approach to killing this system and is an open invitation to return to the presidential campaign financing abuses of the past. We strongly urge you to oppose efforts to repeal the dollar tax check-off.

* * *

In conclusion, we welcome President Reagan's commitment to fight for comprehensive tax reform. His plan provides a valuable basis for the deliberations of this Committee and the Congress.

As the Committee considers the President's plan, we urge that you focus on the fairness and revenue issues that have come to the forefront. Revenues are critical if we are going to deal successfully with the enormous budget deficits facing the nation -- we simply cannot afford to lose any more of the government's revenue base. Fairness is critical because it will determine most of all whether tax reform will be credible with the public. That in turn means that a tax reform plan needs to be based on understandable principles, and not simply reflect the political pressures applied by powerful special interest groups. This is not the time to be playing favorites. Getting on the slippery slope of concessions to interest groups is the surest way to erode the political momentum in favor of tax reform.

We commend the Committee for moving quickly to consider this historic legislative effort and we look forward to working with you in the enormous job that lies ahead.

Testimony of Richard H. Fink
President of Citizens for a Sound Economy
on Tax Simplification
Before the Senate Finance Committee
June [redacted], 1985

Thank you, Mr. Chairman, for this opportunity to describe to you my organization's views on tax reform and tax simplification. Briefly, I am president of Citizens for a Sound Economy a public-interest group with a membership of 100,000 whose main concerns are tax reform, retirement policy reform, privatization, and international free trade. I am also a research associate professor of economics of George Mason University. We believe in returning economic decision-making to citizens.

In short, we support tax simplification to the extent that it is part of a workable and coherent strategy to reduce taxes and the overall burden of government, thereby uniting taxpayers in a common effort to reduce the misallocation of resources caused by the current tax-and-budget structure.

No tax system can be totally "neutral," i.e., without any effect on the economic system whatsoever. But some systems produce more distortions than others, and, as a general rule of thumb, the more complex it is, the more distortions it induces. The present complex system of tax preferences has led consumers, investors, and entrepreneurs to allocate their resources in ways that would be wasteful in the absence of the special rules and which generate overall economic losses in the process. A

simplified, flattened tax system with lower marginal rates would reduce economic uncertainty and reduce the resulting misallocation of resources caused by the proliferation of inefficient tax shelters.

Imposed only seventy-two years ago, the federal income tax has spawned an incomprehensible 40,000 pages of rules, regulations, and interpretations. The 1040 form came with but one page of instructions in 1913; this year taxpayers received a fifty-page booklet, including an order blank for 354 pages of additional forms and instructions for deductions, credits, exemptions, and exclusions.

On the issue of simplicity we cannot fully embrace the President's tax reform proposals. The proposal itself runs 461 pages and took months to prepare. Citizens for a Sound Economy believes that the President's proposals are a step in the right direction but further reforms are needed in order to promote a real "American Revolution" of fairness, simplicity, and growth.

Though the percentage of taxpayers filing the long form would fall, one third of us would still have to suffer through the 1040. Tax simplification can not exist when for example, such matters as the proposed new rules regarding health insurance, which would include in gross income up to $10 per month (or $120 per year) per individual-covered employee or $25 per month (or $300 per year) for family coverage per employee remains in the tax code.

We believe that a real simplified tax system would tax everyone at the same rate and treat all types of different income alike. As long as the complex system of progressive taxation exists, people will have an incentive to try to shift income into different forms and time periods. And this means more IRS regulations--and more lawyers and accountants trying to get around the regulations.

President Reagan has moved the debate in the right direction, but we believe that the political system should be pushed the rest of the way with the 10/10/10 program, which I would like to insert in the Record at this time.

The 10/10/10 plan offers a dramatic break from the present system. Not only does the proposal reform complexity of the tax system, but it also addresses the problems of unfair enforcement procedures and the burgeoning deficit.

Without requiring 461 pages to explain, the 10/10/10 plan calls for a ten percent tax with no deductions, a ten percent cut in federal spending, and a ten point taxpayers bill of rights. There would be a flat marginal tax rate on individual and corporate income, as well as on capital gains. All income, whether in wages, interest in municipal bonds, government payments, or fringe benefits would be treated as taxable compensation. Taxation of the poor would be eliminated by taxing income over the poverty line (an estimated $10,600 for a family of four.)

The single tax rate would bind taxpayers together, eliminating their incentive to try to force those in different brackets to pay for the cost of government. Any proposal for a tax increase would affect every taxpayer; thus, it would be easier to organize taxpayers to oppose lobbying by narrow special interests groups for new and extravagant spending proposals.

Also, by broadening the tax base and eliminating every "loophole," the tax system would preserve horizontal equity. That is, individuals with equal pre-tax incomes would have equal disposable incomes.

The 10/10/10 plan would be simple to understand and simple to comply with. No longer would most taxpayers spend hours knee-deep in tax forms; a postcard would do. The plan would also be fair, treating all taxpayers equally, and protecting them from arbitrary treatment by the IRS. Finally, the 10/10/10 plan would promote economic growth and cut the deficit -- without engaging in the fiction of reducing the tax burden on individuals by hitting business more.

Mr. Chairman, Americans deserve a second tax revolution. The 10/10/10 plan truly gives us one.

"THE 10/10/10 PLAN: BLUEPRINT FOR LONG-TERM PROSPERITY"

by

Robert Capozzi
and
Jeffrey C. Smith

THE NEED FOR REFORM

Imposed only seventy-two years ago, the federal income tax has spawned an incomprehensible 40,000 pages of rules, regulations, and interpretations. The 1040 form came with but one page of instructions in 1913; this year taxpayers received a fifty-page booklet, including an order blank for 354 pages of additional forms and instructions for deductions, credits, and itemizations.

At the same time tax rates have skyrocketed. Originally set at 7 percent, the top rate soon hit 94 percent. That confiscatory rate was gradually lowered to 50 percent only in 1981.

In 1913 the personal income tax raised a minuscule amount of about $28,000. This year the tax will raise almost $400 billion. Indeed, not until the late 1950's did the federal government collect, cumulatively, as much in individual payments as it took in last year alone.

As government revenues have increased, so have expenditures. Even if Congress passes one of the proposed budget compromises, federal spending next year will approach $1 trillion, twice what it was in 1979, triple the level in 1975, and nearly ten times federal outlays just two decades ago. Only once has the budget been in balance since 1961; this year the annual deficit will hit a record $220 billion. Without meaningful expenditure reductions, the total national debt will double in the coming decade.

Unfortunately, the promise of the Reagan administration to turn around the growth of government has been largely unfulfilled. Real spending has increased almost as much as during Reagan's first term, 3.4 percent annually, as it did under Carter, 3.9 percent. Indeed, in 1983 federal outlays took a peacetime record 25 percent of the total Gross National Product.

Along with rising income taxes has come increasing resistance to the higher levies and more draconian enforcement measures. Indeed, the IRS has become perhaps the most intrusive agency in government, consciously trying to frighten Americans into compliance. Nevertheless, IRS Commissioner Roscoe Egger recently testified before Congress that the public was an "uncomfortably short step" from tolerating tax evasion. The percentage of people willingly paying their total tax due has been falling, he warns, and the

agency's enforcement efforts are increasingly being met by violence. For example, the number of reported assaults and threats against IRS agents last year, 789, was up 49 percent over 1983. Reform is needed, Egger said, to make taxes fairer and easier to collect. Otherwise, widespread evasion "may be impossible to turn around."

The combination of ever greater complexity, higher rates, and more arbitrary enforcement is planting the seeds of a second revolution. The first revolution, which gave birth to our nation, was also a fight over taxes, and it toppled the political establishment; today the important question is whether our elected officials will promote or obstruct the fundamental changes in American tax policy that are becoming inevitable.

THE 10/10/10 PLAN

This proposal would represent just the needed revolution in tax and budget policy. Each component of the 10/10/10 plan would respond to a particular problem caused by the current system.

TEN PERCENT FLAT TAX

The plan would impose one marginal tax rate of ten percent; the tax base would include all income above the poverty line, currently an estimated $10,600 for a family of four (see Appendix A). This income exclusion would be indexed to the official poverty line estimate to ensure that the very poor would no longer have to pay taxes.

The single tax rate would bind taxpayers together, eliminating their incentive to try to force those in different brackets to pay for the cost of government. Any proposal for a tax increase would affect every taxpayer; thus, it would be easier to organize taxpayers to oppose lobbying by narrow interests groups for new and extravagant spending proposals.

Also, by broadening the tax base and eliminating every "loophole", the tax system would preserve horizontal equity. That is, individuals with equal pre-tax incomes would have equal disposable incomes.

Thus, the form of the taxpayer's income, whether wages, interest on municipal bonds, government payments, or fringe benefits, would no longer affect his tax liability. Taxation of fringe benefits is particularly controversial, but programs such as employer-paid health insurance are as much compensation as would be roughly the equivalent amount paid in additional salary. Including these benefits in the income base is not intended to discourage the use of fringe benefits; instead, the proposal would treat equally employees who do and do not receive lucrative, tax-exempt, extras.

Some observers have argued that savings should be exempt from the income tax -- in effect, that the same income stream should not be taxed twice. Although the current system is biased against savings, lowering marginal rates would minimize this problem. Moreover, to exempt savings would be to create new perceived inequities, undermining the attractiveness of the entire reform package.

Moreover, the form of a taxpayer's expenditures, whether as home mortgage interest, campaign contributions, or whatever, would not increase or decrease his tax burden either. The federal government would no longer favor one form of consumption over another, eliminating tax considerations as a part of peoples' allocation decisions. A low, simple tax, with a stable, broad base would leave taxpayers with more of their money and reduce their incentive to waste valuable resources attempting to comply with, or avoid, the tax system.

TEN PERCENT CUT IN FEDERAL SPENDING

In Washington the term "budget cut" has been taken to mean a reduction in proposed increases. Thus, the Senate and House budget plans, which envision spending next year of $965 billion and $967.2 billion, respectively, are each said to cut the budget by roughly $56 billion. Yet even if the proposed reductions are genuine, and many observers question the estimates, federal outlays will still be several billion dollars greater than the estimated $959.1 billion in spending this year (see Appendix B).

Therefore, the 10/10/10 plan would entail an actual ten percent cut in the budget, resulting in expenditures of $876 billion. Such a reduction would not only reverse the steady growth of government over the past five decades; it would also more than cut in

half the estimated FY 1986 deficit. And with a total national debt expected to top $1.84 trillion at the end of the year, it is imperative that the budget be brought into balance as quickly as possible; otherwise, federal interest payments, currently the fastest growing program, will continue to skyrocket.

Spending reductions are the proper way to address the deficit problem. Tax increases, since they discourage productive investment, saving, and work, rarely raise as much money as they are intended to. Increasing the funds available to Congress also relaxes any pressure the legislators may feel to restrain spending.

Moreover, the huge increase in the deficit under Reagan is due to out-of-control federal spending, not excessive tax cuts. Reagan's 1981 tax bill gave an estimated $1.488 billion back to taxpayers between 1981 and 1988. However, the president's four tax increases, along with Social Security tax hikes passed in 1977 and inflation-induced bracket creep before indexing took effect, have eaten up all but $63 million of the savings. In contrast, the aggregate deficit over the same period will be roughly $1.3 trillion.

A ten percent budget cut is clearly achievable if Congress is willing to listen less to the chorus of special pleaders who are feasting at the public trough.

Moreover, an expanded campaign to combat fraud and waste, and to eliminate intentional inefficiencies designed to enrich particular groups, could save billions more. The Grace Commission made 2,478 recommendations that it figured could save $424 billion over a three-year period. It is clear from the Commission's report that the potential for savings from better management principles is immense. Privatization, contracting-out, tighter management control, better accounting, and improved procurement procedures are among the simple and time-tested approaches proposed by the Commission.

If Congress and the administration failed to adopt specific program reductions by October 1st, the start of the next fiscal year, an across-the-board ten percent cut would take affect under the 10/10/10 plan. Such an action would pose some obvious difficulties -- interest, for example, couldn't be cut, and eligibility

standards for entitlements programs would have to get changed -- but the threat of this sort of reduction should galvanize Congress, and the interest groups, to come up with a budget that complies with the law.

TEN POINT TAXPAYER BILL OF RIGHTS

The first American Revolution was about arbitrary taxation, yet the IRS has begun to act as unfairly as its British forebears. The 10/10/10 plan would rein in the errant agency.

First, with a simple ten percent flat tax, much of the present enforcement work of the IRS would become unnecessary. The elimination of tax shelters and the multitude of tax preferences, in particular, would eliminate time-consuming investigations of tax shelter promotions and audits involving the propriety of specific deductions. For most individuals, the sole question would be the accuracy of their declared income. Thus, the IRS budget, which has grown 1050 percent in nominal terms and 284 percent in real terms since 1958, could be cut more than ten percent (see Appendix C).

Second, strict rules and regulations would be adopted to protect taxpayers. In particular, the power of the IRS to seize property and otherwise harass taxpayers would be restricted (see Appendix D). The IRS's procedures would have to conform to the rules of just conduct that the courts impose on private debt collection agencies. Today many agents have a "grab first, talk later" attitude, which not only can ruin innocent taxpayers and even uninvolved bystanders, but also frequently costs the government money by, for example, shutting-down businesses rather than working out installment repayment agreements.

A REAL REVOLUTION

When Ronald Reagan went on television on May 28th to present his Second American Revolution, he made a strong case for tax reform. His proposal has many positive points, and moves the debate in the right direction. However, it is no revolution. And as long as Reagan, as well as congressional leaders like House Ways and Means Committee Chairman Dan Rostenkowski, are

willing to face the immense political pressure from every special interest group that has something to lose from reform, they might as well support a program that is truly revolutionary.

The 10/10/10 plan, in contrast, offers a dramatic break from the present system. Moreover, not only does the proposal reform the tax system, but it also addresses the problems of unfair enforcement procedures and the burgeoning deficit.

This program also better meets the objectives upon which Reagan is selling his plan: simplicity, fairness, and economic growth. And by lowering corporate income tax rates as well, the 10/10/10 proposal raises more of the overall tax burden above ground. More specifically, regarding:

Simplicity. The Reagan plan is simpler, but hardly simple. Indeed, the proposal itself runs 461 pages and took months to draft.

Though the percent of taxpayers filing the long form would fall, one third of us would still have to use the complex 1040. Some deductions would be eliminated, but others, like professional expenses, would remain, only with a new adjusted gross income threshold. For example, with a $25 limit and a 50% deduction above that, the administration would greatly complicate record-keeping for the business meals deduction.

Moreover, the key to real simplicity is equal tax rates and equal treatment of all forms of income. As long as rates are graduated, taxpayers will always have an incentive to try to shift income into different forms and over different time periods.

Fairness. The President would lower overall rates and drop some of the very poor from the tax rolls altogether, two important steps. Yet, again, the resulting tax system is hardly fair.

First, progressive tax rates remain. Though progressivity is considered one of the sacred cows of American politics, it cannot be justified as "fair"; there simply is no moral basis for taxing those who are more adept at gaining wealth at successively higher rates. (Ironically, progressivity is unfair to lower wage earners in that it makes any given deduction, like for home mortgage interest, worth more to higher income people.)

Second, the Reagan plan continues to make arbitrary distinctions between various forms of earnings. Most fringe benefits would still be treated preferentially; ordinary income would continue to be taxed at a higher rate than capital gains. Interest on some municipal bonds would remain untaxed, as would most government payments, such as food stamps and, for the most part, Social Security benefits.

Third, real fairness implies a tax code that any taxpayer can understand. Despite Reagan's touted revolution, the tax code will remain incredibly complicated -- and intelligible only to an accountant or lawyer.

Indeed, Congress has changed federal tax law, in the name of reform, almost on an annual basis over the last three decades. But these changes have, in large part, only made the system more complex and inequitable. And as significant as are the administration's proposed changes, they do not fundamentally transform the system. There's every reason to believe that, even if the Reagan plan passes this year, lobbyists by the dozens will be back next year with multiple suggestions for "fine-tuning" the system. Only a truly revolutionary change, like the 10/10/10 plan, will prove to be the tax reform to end all tax reform.

Fourth, the Reagan program doesn't deal with IRS procedures. As long as people have to report their incomes and prove their deductions, they will continue to face harassment by an agency that many believe is out-of-control. Even the fairest tax system in theory is a disaster when the enforcement agency can act arbitrarily. The 10/10/10 plan, in contrast, would restore the balance between taxpayers' rights and IRS's enforcement powers.

Economic Growth. Lowering overall tax rates certainly will encourage economic growth, but dropping them even further would greatly increase the incentive to invest, save, and work. People make decisions at the margin, so to speak, and a marginal tax rate of 35 percent, as proposed by the administration, will still discourage economically productive activity.

Reagan's reform would reduce the amount of time and money spent to avoid the tax system, but not essentially eliminate it, as would the 10/10/10 plan. Under the low 10% flat rate proposed in the 10/10/10

plan these deductions would not only become less valuable but nearly everyone will be paying less in taxes than they are now without them.

Indeed, Reagan has not coupled his plan with any effort to deal with the deficit, despite the threat the tidal wave of red ink poses to the economy. Given the effort the President is making to sell the reform plan, avoiding the deficit issue is a critical flaw since tax reform without deficit reduction is more likely to open the door for future tax increases.

Business Taxes. The administration's plan is most effective in meeting its goal of increasing the tax burden on business; by 1990 corporate tax receipts are expected to rise by 22.5 percent. Overall, the ratio of corporate income tax revenues to personal income tax revenues will increase from approximately 1:5 to 1:3.5.

However, as popular as the step may be -- people always support reform that makes someone else pay more and them pay less -- it really will not reduce personal tax burdens. The point is, the corporate income tax is a hidden tax which actually falls on individuals, only as consumers, shareholders, and employees. As Reagan himself declared in a syndicated radio broadcast three years before he become President, "Government can't tax things like businesses or corporations. It can only tax people." Therefore, we should be making the tax burden more, not less, visible to the people who bear it. And the 10/10/10 plan, by reducing corporate income tax rates as well as those for individuals, would make the price of government more explicit, allowing people to better assess the costs and benefits of the public services they receive.

IS THE 10/10/10 PLAN POLITICALLY REALISTIC?

The Treasury Department reportedly considered proposing a true flat rate tax plan, but dropped it over concern about its political salability. However, if history -- and Ronald Reagan -- teach us anything, it is that political realism is a fleeting concept. Much of the history of American politics is electing the unelectable and enacting the unenactable.

For example, Reagan wasn't supposed to be elected in 1980, and the political system was said to be so ossified that nothing significant could be done to affect taxes or spending. But it's now 1985, and

President Reagan has just been overwhelmingly reelected after cutting tax rates by 25 percent and dramatically reshaping budget priorities.

Tax reform has become perhaps the single most important issue on the political agenda. Unfortunately, what began as a push for a pure, broad-based tax has been progressively watered-down; today Reagan's plan provides only a modest improvement over the current system.

Yet tax reform will succeed only if the reformers are able to rally the American people against the interests who oppose any tampering with their tax preferences. As it stands now, however, Reagan has roused the opposition without giving people a clear enough reason to fight for his program.

In contrast, the 10/10/10 plan would be simple to understand and simple to comply with. No longer would most taxpayers spend hours knee-deep in tax forms; a postcard would do. The plan would also be fair, treating all taxpayers equally, and protecting them from arbitrary treatment by the IRS. Finally, the 10/10/10 plan would promote economic growth and cut the deficit -- without engaging in the fiction of reducing the tax burden on individuals by hitting business more.

Fear of "political reality" is causing many American leaders to avoid discussing the fundamental changes that are necessary to solve the serious problems facing our country today. The knowledge that ideas can have great consequence should provide hope to those who believe in a fairer and more efficient tax system. The 10/10/10 plan is the sort of bold idea that could break the current intellectual deadlock and move the country forward.

Americans deserve a second tax revolution. Let's really give them one.

APPENDIX A

1984 Poverty Levels
(Annual Income)

FAMILY SIZE:	POVERTY LINE
1	$ 5,400
2	6,980
3	8,280
4 (average family size)	10,610
5	12,560
6	14,210
7	16,160
8	17,900
9 or more	21,170

SOURCE: U.S. Bureau of the Census

APPENDIX B

TOTAL FEDERAL GOVERNMENT
RECEIPTS AND EXPENDITURES

YEAR	RECEIPTS ($ billions)	RECEIPTS AS A PERCENT OF GNP	EXPENDITURES ($ billions)	EXPENDITURES AS A PERCENT OF GNP
1960	$ 92.5	18.6%	$ 92.2	18.5%
1961	94.4	18.5	97.8	19.2
1962	99.7	18.2	106.8	19.5
1963	106.6	18.4	111.3	19.3
1964	112.7	18.2	118.6	19.2
1965	116.8	17.7	118.4	18.0
1966	130.9	18.1	134.7	18.6
1967	148.9	19.2	157.6	20.3
1968	153.0	18.4	178.1	21.4
1969	186.9	20.5	183.6	20.2
1970	192.8	19.9	195.7	20.2
1971	187.1	18.1	210.2	20.4
1972	207.3	18.4	230.7	20.4
1973	230.8	18.4	245.6	19.6
1974	263.2	19.1	267.9	19.4
1975	279.1	18.9	324.2	21.9
1976	298.1	18.2	364.5	22.2
1977	355.6	19.1	400.5	21.5
1978	399.6	19.1	448.4	21.4
1979	463.3	19.7	491.0	20.8
1980	517.1	20.1	576.7	22.4
1981	599.3	20.8	657.2	22.8
1982	617.8	20.2	728.4	23.8
1983	600.6	18.6	796.0	24.7
1984	666.5	18.6	851.8	23.8
1985 (est.)	736.9	19.0	959.1	24.8
1986* (est.)	793.7	18.9	973.7	23.2

* Projection

Source: Budget of the United States Government (Fiscal Year 1986), Office of Management and Budget.

APPENDIX C

IRS BUDGET/1958-1985

FISCAL YEAR	NOMINAL BUDGET (in thousands)	REAL BUDGET* (in thousands)
1958	$ 337,374	$ 389,667
1959	355,349	406,875
1960	364,250	410,510
1961	413,900	461,912
1962	450,912	497,807
1963	502,170	547,868
1964	550,307	587,178
1965	598,369	633,074
1966	628,539	646,767
1967	664,875	664,875
1968	695,587	667,764
1969	756,943	689,575
1970	879,125	756,048
1971	977,492	805,453
1972	1,129,337	902,340
1973	1,142,767	859,361
1974	1,309,224	887,654
1975	1,586,570	985,260
1976	1,691,520	992,922
1977	1,807,611	992,922
1978	1,967,284	1,007,240
1979	2,144,745	988,727
1980	2,288,498	929,106
1981	2,479,743	910,066
1982	2,671,926	924,486
1983	3,043,012	1,019,409
1984**	3,325,630	1,067,527
1985**	3,541,597	1,104,978
Percentage Increase	1050%	284%

Source: Internal Revenue Service and CSE Analysts

* Calculations based upon U.S. Bureau Labor Statistic data.

** Purchasing power of the dollar estimated for this year.

APPENDIX D

10 POINT
TAXPAYERS BILL OF RIGHTS

1. TAXPAYERS HAVE A RIGHT to a hearing in a court of law before the IRS seizes his property.

2. TAXPAYERS HAVE A RIGHT to be informed by the IRS of his rights when being questioned, auditied, or otherwise investigated by the IRS.

3. TAXPAYERS HAVE A RIGHT to be free of an IRS which imposes a quota system on its agents to perform a minimum number of seizures.

4. TAXPAYERS HAVE A RIGHT to have IRS treat taxpayer cases in a civil manner.

5. TAXPAYERS HAVE A RIGHT to be reimbursed for court fees when successfully defending themselves against the IRS.

6. TAXPAYERS HAVE A RIGHT to be exempt from an IRS levy on all his personal effects up to $20,000 in value and all books, tools, machinery, equipment, and other property of a trade, business or profession up to $10,000 in value.

7. TAXPAYERS HAVE A RIGHT to negotiate with the IRS a reasonable installment plan to pay for taxes which both parties agree are due.

8. TAXPAYERS HAVE A RIGHT not to have levied by the IRS necessities such as a home, automobile used for commuting, or tangible personal property for a business without which the business would close down.

9. TAXPAYERS HAVE A RIGHT not to be levied by the IRS property the value of which is less than the cost of seizure and sale.

10. TAXPAYERS HAVE A RIGHT to receive all rights of due process by the IRS.